No. 92-1612

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

SOUTHERN PACIFIC TRANSPORTATION COMPANY, and ST. LOUIS SOUTHWESTERN RAILWAY COMPANY,
Petitioners,

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA, *et al.*,
Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

The ICC approved a major railroad merger upon the condition that the merging railroads grant to petitioner, a competing railroad, the right to run its trains over portions of the merged system. But for those "trackage rights," which were designed to permit a new, competing transcontinental rail service, the ICC would not have approved the merger. Instead, it would have found the merger to be anticompetitive and not in the public interest. The trackage rights condition was an application of the ICC's merger policy, which was not merely to prevent monopolies, but also to prevent any substantial lessening of competition as a result of a merger. The court of appeals affirmed the ICC's decision approving the merger on the understanding that the ICC would honor and implement that policy in setting the compensation level for the trackage rights. Nevertheless, the ICC departed from its merger policy when it set compensation. The compensation was designed merely to prevent monopoly pricing by the merged system and not to prevent a substantial lessening of competition. The question presented is as follows:

Does the requirement of *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983), that an agency acknowledge and sufficiently explain departures from prior policy, apply, and is it satisfied, when the ICC, in implementing a critical procompetitive condition of a rail merger, departs from the merger policy underlying the condition, and does not acknowledge or explain the departure?

LIST OF PARTIES AND RULE 29.1 LIST

Southern Pacific Transportation Company and St. Louis Southwestern Railway Company, petitioners here, and Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company, were petitioners or intervenor-respondents in consolidated cases in the court of appeals. The Interstate Commerce Commission and the United States of America were respondents in the consolidated cases in the court of appeals.

A list of parent companies and subsidiaries (except wholly owned subsidiaries) of Southern Pacific Transportation Company and St. Louis Southwestern Railway Company (which itself is a subsidiary of Southern Pacific Transportation Company) is as follows:

Parent companies:

The Anschutz Corporation
Rio Grande Industries, Inc.
SPTC Holding, Inc.

Subsidiaries:

Alton & Southern Ry. Co.
Arkansas & Memphis Ry. Bridge and Terminal Co.
Central California Traction Co.
Harbor Belt Line R.R. (nonincorporated joint agency)
Kansas City Terminal Ry. Co.
Ogden Union Ry. & Depot Co.
Portland Terminal R.R. Co.
Portland Traction Co.
Southern Illinois and Missouri Bridge Co.
Sunset Ry. Co.
Terminal R.R. Association of St. Louis
TTX Co.

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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PETITION FOR A WRIT

Petitioners Southern Pacific Transportation Company and St. Louis Southwestern Railway Company (collectively, "SP") hereby request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit, filed October 30, 1992.

OPINIONS BELOW

The opinion of the court of appeals is not reported and is reprinted in the Appendix hereto ("App.") at

1a-3a. The orders of the court of appeals denying SP's petition for rehearing and suggestion of rehearing *en banc* are not reported and are reprinted at App. 4a and 5a, respectively.

The opinions of the Interstate Commerce Commission ("ICC") are listed in the margin, and are reprinted beginning at App. 7a.[1]

JURISDICTION

The judgment of the court of appeals was entered on October 30, 1992 (App. 1a). On January 6, 1993, the court of appeals denied SP's timely request for a rehearing and suggestion for rehearing *en banc*. This petition is filed within 90 days of the order denying rehearing.

SP invokes the jurisdiction of this Court under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case arises under the Interstate Commerce Act. In the rulings at issue, the ICC purported to implement a condition previously imposed by it in a rail merger proceeding. The pertinent statutory provisions are at 49 U.S.C. §§ 10101a, 10704(a)(2), 10709(a), 11341(a), 11343(a), 11344(b)(1)(E), 11344(c). These provisions are reprinted at App. 200a-205a.

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[1] *St. Louis S.W. Ry.—Trackage Rights Over Mo. Pac. R.R.—Kansas City to St. Louis*, 1 I.C.C.2d 776 (1984) ("*Compensation I*"); 4 I.C.C.2d 668 (1987) ("*Compensation II*"); 5 I.C.C.2d 525 (1989) ("*Compensation III*"); 8 I.C.C.2d 80 (1991) ("*Compensation IV*"); 8 I.C.C.2d 213 (1991) ("*Compensation V*").

STATEMENT OF THE CASE

A. Basis for Jurisdiction Below

The court of appeals had jurisdiction under 28 U.S.C. §§ 2321 and 2342 to review the final orders of the ICC in this case.

B. The ICC's Merger Authority

Railroads seeking to merge with each other require the approval of the ICC.[2] Once the ICC approves a merger, the merging carriers are exempt from the antitrust laws to the extent necessary to carry out the approved transaction.

Railroad competition is a central element in the ICC's evaluation of merger applications. *Union Pac. Corp.—Control—Missouri Pac. Corp.*, 366 I.C.C. 462, 501-02 (1982) ("*UP-MP Merger*"), *aff'd sub nom. Southern Pac. Transp. Co. v. ICC*, 736 F.2d 709 (D.C. Cir. 1984), *cert. denied sub nom. Brotherhood of Maintenance of Way Employees v. United States*, 469 U.S. 1208 (1985). For transactions involving two or more large railroads ("Class I railroads"), the ICC is required to apply a public interest standard, which includes among its enumerated elements whether the proposed transaction "would have an adverse effect on competition among rail carriers in the affected region." Section 11344(b)(1)(E).[3] In the National Rail

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[2] The requirement for ICC approval applies to all forms of common control, including consolidations short of full merger. *See* 49 U.S.C. § 11343 (1988). For convenience, SP will refer to all control transactions subject to the prior approval requirement as mergers.

[3] Hereafter, all references to statutory sections are to Title 49 of the U.S. Code (1988), unless otherwise indicated.

Transportation Policy enacted as part of the Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895, Congress declared that the policy of the United States is "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail." Section 10101a(1). This policy has "increased the need to identify carefully any anticompetitive effects" of a proposed rail merger, which are then balanced against anticipated benefits. *UP-MP Merger*, 366 I.C.C. at 502.[4]

Through Section 7 of the Clayton Act, 15 U.S.C. § 18 (1988), Congress has required that the anticompetitive consequences of mergers be prevented in their incipiency. *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 597 (1957). The ICC considers that policy of Section 7 to be an element of the public interest standard governing major rail mergers. *See UP-MP Merger*, 366 I.C.C. at 501. When the ICC assesses potential anticompetitive effects of rail mergers, it utilizes the principles of Section 7. *See id.* at 502-506.

Section 7 on its face distinguishes a substantial lessening of competition from creation of monopoly.[5] So

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[4] Although the ICC does not enforce the antitrust laws as such, *McLean Trucking Co. v. United States*, 321 U.S. 67, 79-80 (1944), competition is "significant chiefly as it aids in the attainment of the objectives of the national transportation policy," *id.* at 85-86. National policy at the time of *McLean Trucking* did not give the emphasis to competition that is now contained in the National Rail Transportation Policy. *Compare id.* at 82-83 *with* 49 U.S.C. § 10101a(1).

[5] Section 7 states that mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly"

does the ICC's merger policy. If a proposed rail merger would be likely to result in a substantial *lessening* of competition, even if the remaining competition would be sufficient to prevent the merged system from obtaining monopoly power, the ICC will not approve the merger unless it can design procompetitive conditions to offset the lessening in competition.[6] It will then approve the merger subject to these conditions. *See, e.g., Southern Pac. Transp. Co. v. ICC*, 736 F.2d 708, 712 (D.C. Cir. 1984) ("*SPT*"), *cert. denied sub nom. Brotherhood of Maintenance of Way Employees v. United States*, 469 U.S. 1208 (1985). The ICC's conditioning authority is explicit (Section 11344(c)), and is "not limited to conditions proposed or favored by the carriers." *New York Cent. Sec. Corp. v. United States*, 287 U.S. 12, 28 (1932). If a condition is necessary to render a proposed merger in the public interest, the ICC may not approve the merger without the condition. *Baltimore & O. R.R. v. United States*, 386 U.S. 372, 388-90 (1967).

A frequently imposed condition is that the merging railroads allow one or more competing railroads to run trains over designated portions of the merged system. Through these "trackage rights," the ICC is

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are prohibited. *See United States v. E. I. du Pont de Nemours & Co.*, 353 U.S. at 589 (distinguishing prevention of monopoly from prevention of substantial lessening).

[6] Anticompetitive effects may occur because the merging railroads have parallel lines, and, therefore, are direct competitors. Where the two railroads are end-to-end, meeting at commonly served points, the merger might result in the vertical foreclosure of competing railroads, or in a reduction in competition for movements between the commonly served points and other origins and destinations, so-called "source" competition.

able to create new rail routes, or augment existing routes, to compete with the merged system.

Under a trackage rights condition, the new competition is not based on the provision of alternate railroad facilities. Instead, the new competitor uses the track of the merged system. The merged system supplies track space both to its own shippers and to the trackage rights grantees. The merged system is the grantor and the potential competitor is the grantee. For this reason, the compensation paid for the trackage rights is a critical determinant of the tenant railroad's ability to provide the level of competition that would otherwise be lessened by the merger.

C. The Union Pacific Merger

In 1982, three major railroads, the Union Pacific Railroad ("UPRR"), the Western Pacific Railroad ("WP"), and the Missouri Pacific Railroad ("MP") (collectively, "UP") received the approval of the ICC to merge. The ICC found that the merger, as proposed, was not in the public interest because it would have had serious anticompetitive effects. The ICC examined "both the parallel and end-to-end effects (roughly analogous to horizontal and vertical effects, respectively . . .)." *SPT*, 736 F.2d at 718. This examination showed that the merger would have "significant adverse competitive effect" in the central corridor—the rail corridor across the center of the country between the West Coast and the Midwest, via interchanges in Utah and Colorado. *UP-MP Merger*, 366 I.C.C. at 533. UP's post-merger market share, for example, would have been "extremely high by conventional antitrust standards." *Id.* at 512. The ICC said that the "substantial lessening of competition" in the central corridor "must be redressed if

we are to approve the proposed transactions." *Id.* at 525.

The ICC believed that it could redress the anticompetitive effects by approving the merger subject to certain procompetitive conditions, and did so. The applicant railroads accepted the conditions and consummated the merger. The result was to create the second largest rail system in the United States, and to change the face of rail competition in the West.

The ICC's key condition was that the UP grant SP and another railroad, the Denver and Rio Grande Western ("DRGW"), the right to run their trains over certain portions of the merged UP. Those trackage rights, in conjunction with existing routes of SP and DRGW, would create a new rail route in the central corridor to compete with UP.[7] These trackage rights, the ICC said, would "*offset* reductions in competition" and "*preserve* the competitive balance." *Id.* at 587, 589 (emphasis added). The trackage rights were thus designed to prevent any substantial lessening of competition, in accordance with the ICC's merger policy.

The ICC recognized, however, that the effectiveness of the trackage rights depended heavily upon the compensation that SP and DRGW would pay to UP for the exercise of the rights. SP and DRGW would be

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[7] SP owned lines between Oakland, California and Salt Lake City. At Salt Lake City, SP could interchange with DRGW, which owned lines running between there and Pueblo, Colorado, south of Denver. From Pueblo to St. Louis, the new route would consist of trackage rights over MP, one of the merging railroads. Between Pueblo and Kansas City, DRGW received the trackage rights; between Kansas City and St. Louis, SP received the trackage rights. The trackage rights apply to both eastbound and westbound trains.

competing with UP over UP track. The more that SP was required to pay UP, the less margin it would have to compete vigorously with UP for the same business. Whether the anticompetitive potential of the merger would be frustrated depended, the ICC said, on "the ability of DRGW and SP to fashion effective competitive responses to the consolidated system." *Id.* at 514. The public interest required the preservation of competitive balance; competitive balance required the trackage rights; and the "key to the success of the [trackage rights] conditions lies in the terms of compensation . . . ." *Compensation I*, 1 I.C.C.2d at 779, App. 12a.

Although compensation was the key to the competitive restraint afforded by the trackage rights, the ICC did not resolve the issue of compensation in its decision approving the UP merger. Instead, it stated general compensation principles that it would apply in the event the parties failed to agree on compensation terms that were consistent with the competitive purpose of the trackage rights.

SP argued on judicial review of the ICC's *UP-MP Merger* decision that, because compensation was the critical issue, proper judicial review was impossible unless and until compensation had been determined. The court of appeals nevertheless affirmed the ICC's conditioned approval of the UP merger. The court found that the ICC had "specifically provided that the [compensation] terms . . . *must be such as to make the new transcontinental corridor (SP/DRGW) competitive* with the merged system." *SPT*, 736 F.2d at 721 (emphasis added). The court added that

> we trust the Commission to *ensure* that the compensation terms will not defeat the pur-

> pose of the trackage rights. The ICC has in fact *guaranteed* that it will see to the proper functioning of the trackage rights.

Id. (emphasis added). The court affirmed the ICC's conclusion that, "[a]s conditioned," the "public benefits from the consolidations outweighed their negative effects." *Id.* at 712.

Thereafter, negotiations over compensation failed and the ICC began the compensation proceeding that gave rise to the instant controversy.[8]

D. The Course of Proceedings and Disposition Below

1. The issue in the compensation proceeding

There was no question in the compensation proceeding that SP should reimburse UP for costs that SP causes by reason of its use of the line between Kansas City and St. Louis, as well as for an equitable share of UP's out-of-pocket costs of maintaining and operating the line. The controversy concerned an al-

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[8] During the pendency of the compensation proceeding, SP has been operating under an interim agreement with UP, under which SP pays UP a certain monthly fee for the trackage rights. The ICC held that in order to ensure that UP is made "whole" in the event the amount eventually owing is larger than the monthly payments, SP must pay compound interest on the difference. *Compensation I*, 1 I.C.C.2d at 792, 805. DRGW has been operating under a settlement with UP entered into shortly after the compensation proceeding began. In 1988, SP and DRGW themselves came under common control. That did not reduce the importance of an SP-DRGW route to compete with UP in the central corridor, nor did it change the fact that the trackage rights were essential to that route. *See Rio Grande Indus., Inc.—Control—Southern Pac. Transp. Co.*, 4 I.C.C.2d 834, 908 (1988), *aff'd sub nom. Kansas City S. Indus., Inc. v. ICC*, 902 F.2d 423 (5th Cir. 1990) ("*SP-DRGW*").

leged tension between two basic regulatory goals. One goal was to compensate UP for the cost of the equity capital invested in the line (which the parties and ICC referred to as the "rental" component of trackage rights compensation). As a matter of principle, UP should have an opportunity, when the market allowed, to become "revenue adequate" by earning the "cost of capital"—the returns that investors must expect before putting capital into an enterprise.[9] Cost-causation was not a guide on this issue, because the amount of capital UP invested to acquire the line was not altered by SP's usage. UP's out-of-pocket expenditures were not a guide because the return required by equity investors (unlike that required by lenders) is not a cash obligation.

The other goal was the procompetitive purpose of the trackage rights themselves. SP argued that rental for the trackage rights had to be set so that efficiency was the determinant of competitive success. If compensation were set properly, UP would gain traffic from SP only when UP was the more efficient carrier for the movement. SP would retain or gain traffic for which it was the more efficient carrier.[10] If SP

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[9] The ICC determines the railroad industry cost of capital on an annual basis. *See, e.g., Standards For Railroad Revenue Adequacy*, 364 I.C.C. 803 (1981), *aff'd sub nom. Bessemer & Lake Erie R.R. v. ICC*, 691 F.2d 1104 (3d Cir. 1982), *cert. denied*, 462 U.S. 1110 (1983); *Railroad Revenue Adequacy—1991 Determination*, 8 I.C.C.2d 666 (1992).

[10] Thus, SP was arguing for the protection of competition, not the protection of a competitor. The latter occurs when a nonmerging carrier argues that the ICC should impose conditions that would protect its revenues *regardless* of whether it is the more efficient carrier. SP's argument is that efficiency should be the determining factor.

was not able to do so because of the rental, UP would gain traffic not because it was more efficient but because it had merged. That result would be the opposite of the merger policy that the trackage rights were designed to implement.

The issue in the compensation proceeding arose because, before the merger, MP was earning only what the transportation market allowed it to earn, and the transportation market did not allow it to charge its shippers the cost of capital. SP argued that, if, after the merger, UP was charging SP the cost of capital, the increase would not be due to any change in MP's efficiency, or to a change in the transportation market. It would be due solely to the fact that MP merged and the ICC *set* UP's compensation at the cost of capital, a level that is not determined by the transportation market. UP would be charging SP more than UP was charging its shippers for use of the same line. If SP were paying UP the cost of capital but shippers using UP were not required to pay at that level, SP would be unable to compete effectively with UP.

SP argued that the goals of competition and revenue adequacy would be properly reconciled if UP could earn the cost of capital for use of its tracks from SP whenever UP was charging shippers the same amount. There was no need, therefore, to lessen competition in the interest of UP's revenue adequacy. So long as UP charged all users of its track the same for track rental, competition on the basis of operating costs and service would continue to prevail, and UP would be able to earn the cost of capital whenever the market allowed it to charge its shippers the cost of capital.[11]

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[11] The only economic testimony concerning SP's proposal was

2. The ICC's decisions in the compensation proceeding

The Commission issued its first decision in the compensation proceeding shortly after the court of appeals had affirmed its conditioned approval of the UP merger. The expectation of the court with respect to compensation, expressed as the ICC's "guarantee" of the procompetitive functioning of the trackage rights, was still freshly in mind. The ICC designed its first decision around the procompetitive goal: "[W]e are attempting to place the tenant [SP/DRGW] *in precisely* the position of the owning road [UP]." *Compensation I*, 1 I.C.C.2d at 786, App. 24a (emphasis added). The "tenant *must be able to operate competitively*." Id., App. 25a (emphasis added.)

Subsequently, the ICC determined that its decision in *Compensation I* was flawed. In *Compensation I*, the ICC had set SP's rental at a level that would not have varied with changes in the railroad cost of capital. The rental might have been below the cost of capital in some years, and above it in others. The ICC concluded in *Compensation II* that if SP paid rental at that prescribed level, the ICC might be "perpetuating" an insufficient return for UP. *Compensation II*, 4 I.C.C.2d at 682 App. 84a-85a. The ICC's concern was that UP might be unable to attain revenue adequacy even in years when market conditions would allow it to charge its shippers the cost of capital, because SP would be paying a lesser amount.

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in support of the proposal. This testimony was from the two economists who had been *UP's* witnesses on the compensation issue in the *UP-MP Merger* proceeding. *See* ICC Finance Docket No. 30000 (Sub-No. 16), SP Petition to Reconsider and Reopen, Attachment A, Baumol-Willig Verified Statement (Sept. 24, 1991).

As a way to fulfill the goals both of revenue adequacy and competition, SP proposed that rental be set at UP's actual return on investment ("ROI") each year. If market conditions during a year allowed UP to charge its shippers the cost of capital (so that its ROI was the same as the cost of capital), then SP would pay its usage share of the cost of capital. If UP's ROI was less than the cost of capital, SP would pay its usage share of the ROI. In either case, SP would be paying UP the same amount for track space as UP's shippers were paying for track space on the same line.

In its second compensation decision, however, the ICC decided that SP should pay UP a usage share of the cost of capital *regardless* of whether UP was actually charging its shippers the cost of capital. *Id.* This decision created the cost disadvantage to SP that precipitated SP's appeal. In years when UP was not earning the cost of capital from its shippers, SP would be paying UP more than UP's shippers were paying for use of UP's track.[12]

The ICC created a dichotomy between preserving competition and allowing UP the opportunity to earn its cost of capital. The ICC never showed why the dichotomy existed under SP's proposal or how, with a handicap in the rental, SP would be able to retain or gain traffic for which it was the more efficient carrier.[13]

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[12] In no year since the UP-MP merger has UP earned the cost of capital.

[13] SP pointed out that there cannot be any differences in the efficiency of SP and UP that flow from the location or characteristics of the line they are using between Kansas City and

The ICC's refusal to address the fact that there was no necessary dichotomy led it ultimately to assert that SP had not shown the "*relevance*" of evidence showing the effect of the compensation method on SP's "*ability* or willingness to operate the trackage rights." *Compensation IV*, 8 I.C.C.2d at 95, App. 164a (emphasis added). The ICC did not attempt to show how this statement was consistent with its earlier guarantee to the court of appeals that it would set compensation so as to ensure the proper competitive functioning of the trackage rights.

The ICC's insistence that there was a dichotomy between the goal of UP's opportunity for revenue adequacy and the goal of preventing a lessening of competition led the ICC eventually to abandon the latter goal entirely. It was enough that SP would be able "to offer an effective competitive alternative" under *one* set of conditions: "*if* UP were to engage in *monopolistic* pricing practices." *Id.* at 86, App. 152a (emphasis added); *see also id.* at 87, App. 153a. "We intended that the formula would produce an interest rental payment low enough to achieve this purpose, but no lower." *Id.* at 87. The ICC did not explain how a rental intended to do no more than prevent *monopoly* pricing by the merged UP system would prevent post-merger *lessening* of competition and resultant price increases *short* of monopoly levels. A dissenting Commissioner characterized this reasoning

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St. Louis, since both are using the same line. Differences can arise only in the efficiency with which the two railroads move traffic over the line, with respect to operating costs (*e.g.*, fuel, labor, equipment utilization, assembling and other handling of trains), or the quality of the services they offer (*e.g.*, scheduling, accountability, car availability).

as containing a "basic flaw" and as "inconsistent with the Commission's original intent in granting the trackage rights." *Id.* at 111, App. 184a.

3. The proceeding in the court of appeals

Both SP and UP filed timely petitions for judicial review of the ICC's decision.[14] The ICC did not attempt to show how preventing any substantial lessening of competition and merely preventing monopoly pricing were the same policy.[15] Nor did the court of appeals address the issue. In its brief opinion denying both petitions, the court acknowledged that the ICC "did not fully explain why the petitioners' suggested approaches were inferior to its own." Slip op. at 2, App. 3a. SP invoked *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) ("*State Farm*"), as requiring the ICC to explain its change of policy, from prevention of substantial lessening to prevention of monopoly. But the court of appeals treated the issue solely as a matter of deference. It did not recognize the inadequacy of the agency's explanation as a legal issue. Instead, the court said that the petitioners had not demonstrated

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[14] UP insisted that the ICC should have created an even greater cost disadvantage to SP by valuing the line at approximately six times the value that the ICC had assigned to it.

[15] SP pointed out to the court of appeals the position of the Department of Justice that the ICC should not approve a merger if proposed procompetitive conditions "would not *maintain existing price and service competition.*" D.C. Cir. No. 88-1186, Brief of Petitioner Southern Pacific Transportation Company and St. Louis Southwestern Railway Company at 27 n.6 (July 1, 1992), quoting *Santa Fe S. Pac. Corp.—Control—Southern Pac. Transp. Co.*, 3 I.C.C.2d 926, 931 (1987) (emphasis added).

"*clearly and convincingly* a fatal flaw" in the ICC's action; it is not enough for a petitioner "merely to put forth an acceptable alternative." Slip op. at 2, App. 3a. (citation omitted) (emphasis in original).

SP timely filed a petition for rehearing and suggestion for rehearing *en banc*. The court of appeals denied both requests on January 6, 1993.

REASONS FOR GRANTING THE WRIT

This case presents an important question concerning the application of *State Farm*. Petitioners argued below that the ICC initially applied its merger policy when it approved the UP merger subject to certain critical procompetitive conditions; then *abandoned* that policy when it implemented the conditions in a subsequent proceeding; and *neither acknowledged nor explained* the abandonment. The court of appeals acknowledged that the ICC had not explained why its compensation method was superior to SP's, but declined to remand to the agency for further explanation. The court of appeals erroneously failed to require the ICC to address the departure from established policy, and to explain any departure adequately, as required by *State Farm*.

This case is the ICC's leading case on the compensation issue. It bears on the ICC's entire approach to rail competition and the ongoing rationalization of rail facilities through mergers and other consolidations in accordance with congressional intent. It is not a case about an arcane aspect of cost-accounting or rate theory that Congress has entrusted to the ICC's discretion. It is about whether the ICC, having required trackage rights as an indispensable application of its procompetitive rail merger policy, should

have been held to the *State Farm* standard of explanation when it appeared to abandon that merger policy during the crucial step of setting compensation for the trackage rights, without explaining or even acknowledging the reversal.

A.

The application of *State Farm* to the ICC's implementation of rail merger conditions designed to offset anticompetitive effects is essential to the proper administration of the rail merger provisions of the Interstate Commerce Act. Rail mergers and other forms of consolidation play a key role in rationalizing the rail network and realizing statutory objectives of efficiency and sound economic conditions in the industry. *McLean Trucking*, 321 U.S. at 81.[16] To the extent those objectives are realized, the industry is enabled to attract capital and avoid the type of disinvestment that led to the collapse of the Northeastern railroads after World War II.

The ICC, however, cannot itself initiate or order such structural changes, which are left under the Act to private initiative. Railroads can and do propose mergers that will benefit them, and increase efficiency, but at the price of serious anticompetitive effects. The ICC recognized in the *UP-MP Merger* that the competitive freedoms afforded by recent legislation had made it "easier to exert or abuse market power gained as a result of consolidation." *UP-MP*

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[16] For example, rail mergers between railroads that are end-to-end can bring increased flexibility in the pricing of through movements and in negotiating with shippers; the elimination of redundant facilities and overhead; and improved equipment utilization and accountability to shippers.

Merger, 366 I.C.C. at 502. Trackage rights and other forms of mitigating conditions play an essential role in enabling the ICC to refashion merger proposals, so that the anticompetitive effects are offset while the enhanced efficiencies are largely maintained, thereby bringing about *net* public benefits.[17]

As this case illustrates, conditions are meaningless unless they are implemented to achieve their procompetitive purpose. When the ICC gets down to particulars and implements procompetitive conditions, it must exercise its expertise and discretion with fidelity to the procompetitive purpose, and rely upon appropriate reasons. Reviewing courts must be able to determine that the ICC did so. *State Farm* must be applied when the ICC's implementation of a condition appears to depart from the policy that led to the imposition of the condition in the first place.

The problem is a general one, because the potential for departure is *inherent* where the ICC imposes conditions on an otherwise anticompetitive rail merger. The analysis that leads the ICC to identify anticompetitive effects and fashion offsetting conditions is an

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[17] In addition to the trackage rights conditions imposed in the *UP-MP Merger*, *see, e.g.*, *Union Pac. Corp.—Control—Missouri-Kansas-Texas R.R.*, 4 I.C.C.2d 409, 531, ¶ 27 (1988), *pet. for review dismissed*, 883 F.2d 1079 (D.C. Cir. 1989); *CSX Corp.—Control—Chessie Sys., Inc.*, 363 I.C.C. 521, 602, ¶¶ 10 & 12, 603, ¶¶ 27 & 31 (1980), *aff'd sub nom. Brotherhood of Maintenance of Way Employees v. ICC*, 698 F.2d 315 (7th Cir. 1983). In the one major rail merger case in the 1980's where the ICC withheld approval, it did so because it could not satisfactorily design trackage rights or other conditions to offset the anticompetitive effects it found. *See Santa Fe S. Pac. Corp.—Control—Southern Pac. Transp. Co.*, 2 I.C.C.2d 709 (1986), *reconsideration denied*, 3 I.C.C.2d 926 (1987).

antitrust type of analysis. The implementation of conditions does not flow automatically from this analysis. To the contrary, determining the particulars of implementation can involve distinct considerations of a very different type. Certainly that is true with respect to determining compensation. *State Farm* has a particularly important role in such circumstances.

The *State Farm* requirement is also essential to the integrity of judicial review. Trackage rights imposed as a condition of the ICC's approval of a merger are always procompetitive *in concept*. Their very rationale is to offset what would otherwise be the anticompetitive consequences of a proposed merger. If a reviewing court assumes that the trackage rights terms will be defined and implemented by the ICC so as to achieve their procompetitive purpose, a merger conditioned on trackage rights will generally survive judicial review. But a reviewing court can justify this assumption only if it can also assume that it will be able to determine what the agency did with respect to the actual terms for implementation, in particular, compensation.[18]

If a reviewing court accepts less than a full explanation of the reasons for the ICC's method of implementing *nominally* procompetitive conditions, the

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[18] In this case, the court that affirmed the ICC's conditioned approval of the UP merger explicitly assumed that the ICC would set compensation so as to implement the procompetitive purpose of the trackage rights. And the court that reviewed the ICC's compensation decision declined to require a full explanation by the ICC of its compensation decision. The issue is the same, however, whether there is bifurcated review or whether the ICC determines implementation as part of the merger proceeding itself.

ICC's approvals of seriously anticompetitive mergers will be affirmed on unrealistic judicial expectations about the degree to which such conditions will offset anticompetitive effects. Outcomes resting on such judicial misconceptions impair both the proper administration of the Act and the integrity of judicial review. There is only one way to avoid this result. The ICC must apply the same policy in implementing conditions as it uses to impose them initially, or provide a full explanation for any departure. *State Farm* must be applied to ICC implementation decisions that appear to abandon the policy on which the merger condition rests.

B.

The predicate for a *State Farm* issue is, of course, that the agency departed from or appeared to depart from a policy, without acknowledgment or adequate explanation. As petitioners have pointed out, the potential for departure is inherent in compensation decisions, because considerations come into play in determining compensation that are not a part of the antitrust type of analysis that leads to the imposition of a condition in the first place. The predicate is in fact present in this case. The ICC departed from its merger policy and failed to acknowledge that it had done so, but the court of appeals declined to require a full explanation.

When it approved the UP merger, the ICC had required the trackage rights as an application of its merger policy, and the court of appeals had affirmed the ICC's decision. Therefore, SP argued, compensation for the trackage rights had to be consistent with that same policy, which provided a clear answer,

and the only answer, to the question of the proper rental.

Under the ICC's merger policy, the extent of inter-railroad competition existing before the merger is a baseline for assessing the net change in consumer welfare from a proposed merger. Following Section 7 of the Clayton Act and the National Rail Transportation Policy (Section 10101a), the ICC does not allow mergers to cause a significant lessening of inter-railroad competition, *even if* after the merger the remaining competition would be sufficiently effective to deny monopoly power to the merged system.

The trackage rights condition furthered this policy. It was designed to "*offset* reductions in competition" and "*preserve* the competitive balance." 366 I.C.C. at 586-87, 589 (emphasis added). The court of appeals that affirmed the ICC's conditioned approval of the UP merger understood the trackage rights in the same way. The court emphasized that the Commission "*carefully tailored* the trackage rights to *match* anticompetitive effects." *SPT*, 736 F.2d at 720 (emphasis added).

Ultimately, however, the ICC disavowed these purposes. In its final articulation, the ICC claimed that the trackage rights had been intended *only* to enable SP to offer a competitive alternative "*if* UP were to engage in *monopolistic* pricing practices." *Compensation IV*, 8 I.C.C.2d at 86, App. 152a. (emphasis added). The rental paid by SP, the ICC said, had to be "low enough to achieve this purpose, but no lower." *Id.* at 87, App. 153a. This decision assured that UP would not face effective competition until its prices rose from the pre-merger level to the monopoly level. Again, however, the ICC made no attempt to

justify this earnings increase in terms of its merger policy. Because the ICC's policy is to prevent any substantial lessening of competition, an essential element of the policy is that any shifts of traffic to the merged system must be the result of increased efficiency and not increased market power. "Revenue transfers [to merged carriers] which result from *reduced* competition, *or* the ability of a carrier to exact monopoly profits, reflect private benefits which result in harm to the public." *SP-DRGW*, 4 I.C.C.2d at 875 (emphasis added).

When the ICC approved the UP merger subject to the trackage rights condition, it could have said "we are going to allow competition in the central transcontinental corridor to diminish to the point at which UP might be able to charge monopoly prices, and we impose the trackage rights condition, not to prevent any substantial lessening of competition, but only to prevent monopoly prices." That would have been a different decision from the one that the ICC rendered and the court of appeals affirmed.

The ICC, however, did not even acknowledge the difference, much less attempt to explain how compensation that did no more than prevent monopoly pricing would prevent a *lessening* of competition *short* of a deterioration that left UP with monopoly power. The ICC offered not a word of explanation as to how this prevention-of-monopoly pricing rationale could be squared with the policy of preventing any substantial lessening of competition. *See Compensation IV*, 8 I.C.C.2d at 86, 87, App. 152a, 153a.

In the final analysis, by requiring SP to pay UP a usage share of the cost of capital even when UP's ROI—the amount it was charging its own shippers—

is less than the cost of capital, the ICC created a competitive handicap for SP that did not relate to efficiency. When it rejected SP's position, the ICC thus reversed its merger policy of preventing any substantial lessening of competition, which means protecting the opportunity of the more efficient carrier to retain or gain traffic.

The court of appeals recognized that the ICC had not explained why its choice of compensation was superior to SP's, but affirmed on grounds of deference to the agency. Deference, however, is due only *after* the agency has satisfied *State Farm*. *Cf. Seldovia Native Ass'n, Inc. v. Lujan*, 904 F.2d 1335, 1346 (9th Cir. 1990). Without adequate explanation, there is nothing to which the court may defer. This Court should clarify the application and requirements of *State Farm*.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari.

Respectfully submitted,

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April 6, 1993

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No. 92-1612

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

SOUTHERN PACIFIC TRANSPORTATION COMPANY, and ST. LOUIS SOUTHWESTERN RAILWAY COMPANY,
Petitioners,

v.

INTERSTATE COMMERCE COMMISSION and UNITED STATES OF AMERICA, *et al.*,
Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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NOT TO BE PUBLISHED–SEE LOCAL RULE 14
United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT
September Term, 1992

No. 88-1186

Union Pacific Corporation, *et al.*,
Petitioners

v.

Interstate Commerce Commission, *et al.*,
Respondents

FILED OCT 30 1992
RON GARVIN
CLERK

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and Consolidated Case Nos. 89-1443, 89-1483, 91-1529, and 92-1020

ON PETITIONS FOR REVIEW OF ORDERS OF THE INTERSTATE COMMERCE COMMISSION

Before: MIKVA, *Chief Judge*, RUTH B. GINSBURG and SILBERMAN, *Circuit Judges.*

J U D G M E N T

These petitions were considered on the record and on the briefs and oral arguments of counsel. The arguments have been accorded full consideration by the Court and occasion no need for a published opinion. *See* D.C. Cir. Rule 14(c). For the reasons stated in the accompanying memorandum, it is

ORDERED AND ADJUDGED by this Court that the petitions for review be denied.

The Clerk is directed to withhold issuance of the mandate herein until sever (7) days after disposition of any timely petition for rehearing. *See* D.C. Cir. Rule 15.

Per Curiam
For the Court

/s/ Ron Garvin
Ron Garvin
Clerk

MEMORANDUM

The petitioner railroads seek review of orders of the Interstate Commerce Commission ("ICC" or "Commission") setting the rate of compensation that Standard [sic] Pacific ("SP") must pay Union Pacific ("UP") for the exercise of its right to use certain UP track. The Commission approved an earlier railroad consolidation involving UP subject to certain conditions designed to counteract the potentially anti-competitive effects of the merger, including a requirement that the consolidated UP railroad grant trackage rights to SP and other specified railroads in order to allow competitive alternatives for travel across the Central Corridor of the United States between St. Louis and the West. Unable to reach a private agreement, the petitioners entered into proceedings with the Commission that lasted approximately seven years and produced the five trackage rights compensation orders that are the subject of the petitions.

This Court is limited in its scope of review and may only grant the petitions for review in this case if the ICC action was arbitrary, capricious, an abuse of discretion, or unsupported by substantial evidence on the record as a whole. *See Simmons v. Interstate Commerce Commission*, 934 F.2d 363, 367 (D.C. Cir. 1991); *Cross-Sound Ferry Services v. Interstate Commerce Commission*, 873 F.2d 395, 401 (D.C. Cir. 1989). There is substantial evidence on the

record to support the ICC's calculation of tracking compensation and interest on delayed payments. Moreover, throughout the compensation proceedings, the Commission considered vast amounts of technical evidence, reevaluating and reformulating its decisions in light of the objections of the petitioners and the production of new evidence. Although the Commission did not fully explain why the petitioners' suggested approaches were inferior to its own, the burden upon the petitioners is "*not* merely to put forth an acceptable alternative but rather to demonstrate *clearly and convincingly* a fatal flaw in the action taken." *Nader v. Federal Communications Commission*, 520 F.2d 182 (1975), (quoting *Goodman v. Public Service Commission*, 309 A.2d 97, 101 (D.C. 1973)) (emphasis in original). The petitioners have failed to meet this burden and their petitions must therefore be denied.

United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT
September Term, 1992

No. 88-1186

Union Pacific Corporation, et al.,
Petitioner

v.

Interstate Commerce Commission and
United States of America,
Respondent

FILED JAN 06 1993
RON GARVIN
CLERK

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and Consolidated Cases

BEFORE: Mikva, Chief Judge; Ruth B. Ginsburg and Silberman, Circuit Judges

O R D E R

Upon consideration of petitioners' petition for rehearing, filed December 14, 1992, it is

ORDERED, by the Court, that the petition is denied.

Per Curiam
FOR THE COURT:
RON GARVIN, CLERK

BY: /s/ Robert A. Bonner
Robert A. Bonner
Deputy Clerk

United States Court of Appeals
FOR THE DISTRICT OF COLUMBIA CIRCUIT
September Term, 1992

No. 88-1186

Union Pacific Corporation, et al.,
Petitioner

v.

Interstate Commerce Commission, and
United States of America,
Respondent

FILED JAN 06 1993
RON GARVIN
CLERK

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and Consolidated Cases

BEFORE: Mikva, Chief Judge; Wald, Edwards, Ruth B. Ginsburg, Silberman, Buckley, Williams, D. H. Ginsburg, Sentelle, Henderson, and Randolph, Circuit Judges

O R D E R

Petitioners' Suggestion For Rehearing *En Banc* has been circulated to the full Court. No member of the Court requested the taking of a vote thereon. Upon consideration of the foregoing it is

ORDERED, by the Court *en banc*, that the suggestion is denied.

Per Curiam
FOR THE COURT:
RON GARVIN, CLERK

BY: /s/ Robert A. Bonner
Robert A. Bonner
Deputy Clerk

Circuit Judge Randolph did not participate in this matter.

INTERSTATE COMMERCE COMMISSION REPORTS

FINANCE DOCKET NO. 30,000 (SUB-NO. 16)[1]

ST. LOUIS SOUTHWESTERN RAILWAY COMPANY—TRACKAGE RIGHTS OVER MISSOURI PACIFIC RAILROAD COMPANY—KANSAS CITY TO ST. LOUIS

TRACKAGE RIGHTS COMPENSATION

Decided August 20, 1984

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1. In Finance Docket No. 30,000 (Sub-No. 25), the agreements of November 9, 1982, as supplemented January 21, 1983, governing trackage rights compensation between Missouri-Kansas-Texas Railroad Company and Union Pacific Railroad Company and Missouri Pacific Railroad Company are approved.
2. In Finance Docket No. 30,000 (Sub-No. 18), trackage rights compensation will be calculated in three parts: (a) variable costs of operations, (b) a percentage share of all maintenance and operations expenses and taxes based upon tenant's actual usage, and (c) an interest rental component representing return on investment and determined by a capitalized earnings approach.
3. In Finance Docket No. 30,000 (Sub-No. 16), the trackage rights awarded include operations to Missouri Pacific milepost 0.0 in St. Louis, and interchange operations along the Missouri Pacific lines. The interchange rights do not embrace Labadie, MO.

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[1] This decision also embraces Finance Docket No. 30,000 (Sub-No. 18). Denver and Rio Grande Western Railroad Company—Trackage Rights—Missouri Pacific Railroad Company—Between Pueblo, CO and Kansas City, MO, and Finance Docket No. 30,000 (Sub-No. 25), Missouri-Kansas-Texas Railroad Company—Trackage Rights—Missouri Pacific Railroad Company—Between Kansas City, KS and Omaha, NE.

4. In Finance Docket No. 30,000 (Sub-No. 16), trackage rights compensation will be determined in the same manner set forth in the Sub-No. 18 proceeding. The record is kept open for filing of supplemental information necessary to complete this calculation.

5. In Finance Docket No. 30,000 (Sub-No. 16), interim compensation will be paid as agreed by the parties at the level finally determined in this proceeding and effective retroactively to January 6, 1983. Interest at the railroad industry's current cost of debt will accrue on the difference in amounts actually paid and the compensation fixed in this proceeding.

6. In Finance Docket No. 30,000 (Sub-Nos. 16 and 18), landlord retains the right to make improvements to the property without tenants' prior consent. Compensation for improvements will be at their actual cost times landlord's then current cost of capital times tenants' usage share for each improvement. Tenants will have the option to reimburse the landlord for a portion of the construction expense at the time of construction rather than increasing the improvements valuation base.

J. Peter Byrne, Paul A. Conley, Jr., Mark M. Hennelly, Gregg H. Levy, William J. McDonald, Charles A. Miller, Arvid E. Roach II, C. Barry Schafer, M. Lauck Walton, and *Nina K. Wuestling* for Union Pacific Corporation, Pacific Rail System, Inc., Union Pacific Railroad Company, Missouri Pacific Corporation and Missouri Pacific Railroad Company.

John H. Caldwell, Samuel R. Freeman, Denise M. O'Brien, and *Kendall T. Sanford* for Denver and Rio Grande Western Railroad Company.

William R. Denton, Eva Polin, Michael A. Smith, Douglas E. Stephenson, and *Herbert A. Waterman* for Southern Pacific Transportation Company and St. Louis Southwestern Railway Company.

Donald E. Engle, Nicholas P. Moros, and *Donal L. Turkal* for Burlington Northern Railroad Company.

John O'B. Clarke, Jr. and *John J. Sullivan* for the United Transportation Union.

Harold A. Ross for the Brotherhood of Locomotive Engineers.

Decision

By the Commission:

Background

By decision served October 20, 1982, the Commission approved the consolidation of Union Pacific Railroad Company (UPRR or UP), Missouri Pacific Corporation (MPC), Missouri Pacific Railroad Company (MP or MPRR), and the Western Pacific Railroad Company (WPRR or WP) under the common control of Union Pacific Corporation (UPC) and Pacific Rail System, Inc. (Pacific) (all referred to as the UP system). *Union Pacific-Control-Missouri Pacific: Western Pacific*, 366 I.C.C. 459 (1982) (referred to as *UP-MP* or the Consolidation decision). Several railroads, including Southern Pacific Transportation Company (SP) and its subsidiary St. Louis Southwestern Railway Comany (SSW), Denver and Rio Grande Western Railroad Company (DRGW), and the Missouri-Kansas-Texas Railroad Company (MKT), opposed the transaction and filed responsive applications for the imposition of trackage rights conditions.

In *Southern Pacific Transportation Company* v. *I.C.C.*, 82-2253 (D.C. Cir. May 22, 1984), the Court of Appeals affirmed the consolidation decision in all respects material to these proceedings but remanded for further consideration of an unrelated issue.

In approving the consolidation the Commission identified several anticompetitive effects of the transaction which

could be remedied by grants of trackage rights to competing carriers. The greatest competitive impact was identified in the central transcontinental corridor. Based on 1979 market shares, the UPRR share would increase with the consolidation from 75.7 percent to 85.1 percent (westbound) and from 78.0 percent to 85.5 percent (eastbound) in the corridor east of Denver, *UP-MP* at pp. 510-11. These potential increases presume that all preconsolidation MP traffic would shift to the UP system. In order to preserve competition in the central corridor east of Denver, the Commission conditioned approval of the consolidation on a grant of trackage rights to DRGW between Pueblo, CO, and Kansas City, MO. Almost all of MP's preconsolidation transcontinental traffic was delivered to or received from DRGW, *UP-MP* at 571. DRGW's trackage rights to Kansas City precluded DRGW's foreclosure from this market, allowed it to reach major eastern carriers at Kansas City, and ensured a continued competitive presence in the central corridor. Solely on the basis of these trackage rights DRGW should be able to hold its present market share, for it is assured the ability to continue to handle the traffic it handled prior to the consolidation.[2] The Commission concluded that with the Pueblo-Kansas City trackage rights DRGW would remain a successful competitor to UP in the central corridor, *UP-MP* at p. 577. DRGW's competitive presence assures that any post-consolidation traffic shifts to the UP system will occur because UP offers superior service, and not through the exercise of undue market power.

The direct, parallel competition in the central corridor east of Denver was the only market where traditional mar-

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[2] The only exception would be exclusive MP originated or terminated traffic which will probably shift to UP single-system service. However, the shift of this traffic does not reflect a lessening of competition. See *UP-MP* at p. 543. Rather, it reflects the benefits of the consolidation. *UP-MP* at p. 488, and the efficient UP system service.

ket shares, in terms of a percentage of a specific market, were available as a tool for analysis of the consolidation. Because of the prevalence of interchanges, the balance of the central corridor analysis necessarily relied on a measure of "participation shares." Participation shares were defined as the sum of all traffic in the corridor in which either UPRR, MPRR or WPRR participated.

Participation shares cannot be treated in the same manner as traditional market shares in analyzing competitive impacts, although both are expressed in terms of a percentage of an overall market. Market shares represent the business that a firm individually controls, while participation shares, an artificial measure used to reflect interchange, represent the business that a firm participates in with the cooperation of other firms. In the case of interchanged traffic, neither firm exclusively controls the business; thus, one participant in an existing movement generally cannot unilaterally shift that traffic into new patterns as a result of consolidation.

Analysis of participation shares demonstrated the potential impact of the WP acquisition. If showed the worst-case effect if all traffic moving anywhere on the components of the UP system stayed exclusively on the UP system after consolidation. *UP-MP* at p. 513, table 5, and p. 514, table 6. The greater portion of the traffic shown in each table was interchanged with SP at Ogden: 49.1 percent eastbound and 50.3 percent westbound. After consolidation SP has a distinct disincentive to interchange its traffic with UP at Ogden. Granting of trackage rights to DRGW provides SP an alternative outlet to the east and ensures that most of the SP traffic will not move on the UP system. The SP-DRGW route is a strong competitive alternative in the central corridor, *UP-MP* at p. 516 and 579. The worst-case participation shares shown in tables 5 and 6 will be correspondingly reduced.

To further strengthen the central corridor alternative to UP, the Commission granted SP/SSW trackage rights between Kansas City and St. Louis. This allows an SP-DRGW-SP route which should provide excellent service in the corridor. *UP-MP* at pp. 587-88. The SP/SSW trackage rights will also result in a 400-mile shortening of SP's southern corridor transcontinental route, further sharpening competition between SP's southern corridor route and UP's route in the central corridor.

In order to address the loss of a horizontal competitor in the market between Kansas City and Omaha/Council Bluffs, *UP-MP* at p. 526, and to prevent foreclosure of MKT from a significant share of midwestern grain traffic moving to the Gulf, *UP-MP* at p. 530, the Commission conditioned approval on a grant of trackage rights to MKT in that corridor. These rights will preserve the opportunity for MKT to be an effective competitor for traffic, primarily grain, originating at Omaha/Council Bluffs, Lincoln, Atchison, and Topeka.

Each grant of these trackage rights was designed to remedy a specific anti-competitive effect of the consolidation. However, we recognize that the key to the success of the conditions lies in the terms of compensation for use of the trackage rights. The Commission declined to set specific terms for the trackage rights in the consolidation decision, *UP-MP* at pp. 589-90. Cf. *Louisville & N. R. Co.-Merger—Monon Railroad,* 338 I.C.C. 134, 186 (1970). Instead the Commission required the parties to attempt to reach agreement as to the terms of each grant of trackage rights. If the parties failed to agree, the Commission retained jurisdiction to set terms, *UP-MP* at p. 589.

Consummation of the consolidation was allowed without final resolution of the terms of the trackage rights. However, the trackage rights tenants were assured of an interim right to operate pending final settlement of the compensation, *UP-MP* at p. 590.

We now have before us a final agreement on trackage rights terms and compensation covering the MKT operations, and petitions to set the terms and compensation applicable to SP/SSW and DRGW operations. We will address each matter separately.

Summary

DRGW and SP/SSW were unable to reach agreement with UP on terms of compensation for trackage rights over the Pueblo-Kansas City line (DRGW) and the Kansas City-St. Louis line (SP/SSW). They have requested us to set these terms. We have adopted a methodology for computing compensation designed to reimburse UP for (1) variable costs incurred as a result of tenants' operations, (2) tenants' share, on a car-mile percentage use basis, of maintenance and operation (M&O) expense, and (3) tenants' share on a usage basis of an interest rental component representing return on investment. The interest rental component is computed by applying MPC's 1979 pretax rate of return to the value of the subject lines. As we believe that the latter figure should reflect the earnings potential of the lines, we have rejected valuation methods based upon replacement cost and book value urged by various parties in favor of a capitalized earnings approach. An "earnings multiple," representing the ratio of MPC value (outstanding liabilities plus stock purchase price) to 1979 MPC earnings (adjusted for time parity), was applied to 1979 earnings for the respective lines. For the Pueblo-Kansas City line, we have computed an interest rental component of $2,048,565 based on projected usage factors for each segment of the line. As no net revenue figures were available for the Kansas City-St. Louis line, we will direct the parties to submit, within 60 days, calculations based upon the methodology adopted in this decision.

We have also disposed of a number of issues regarding the Kansas City-St. Louis line. We have determined (a) that the terminus of the line in St. Louis is milepost 0.0

near Gratiot Tower, rather than milepost 2.3 near Grand Avenue, as contended by UP, (b) that the trackage rights granted to SSW contemplate interchange at five Missouri points, including Pleasant Hill, but not Labadie, and (c) that there is no basis for requiring SSW to compensate the Burlington Northern Railroad Company for the use of the Grand Avenue Interlocking. Also, we have provided for the payment by SSW of interest on retroactive adjustments to compensation due under an interim operating agreement, and for the separate valuation and compensation of new improvements made to the line.

Finally, we have approved the agreement between UP and MKT for trackage rights between Kansas City and Omaha/Council Bluffs.

Preliminary Matter

The United Transportation Union (UTU) and the Brotherhood of Locomotive Engineers (BLE) have filed petitions in the Sub-No. 16 and Sub-No. 18[3] preceedings requesting that terms of trackage rights applicable to SP/SSW and DRGW operations respectively not be set by the Commission prior to negotiation or arbitration of an implementing agreement between both the landlord and tenant in each case and labor representatives concerning the selection of employees for the operation of the trackage rights. UTU and BLE argue that 49 U.S.C. 11347 requires us to protect the interests of all employees involved in a consolidation proceeding and that this provision mandates a negotiated settlement between employee representatives and both the landlord and tenant carriers as to which employees, landlords' or tenants', are to actually perform tenants' operations. UTU and BLE contend that we cannot set the trackage rights terms absent such an agreement for two

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[3] The UTU petition was late-filed and accompanied by a Motion for Leave to File. We will accept the petition because it does not unduly broaden the issues before us.

reasons. First, they contend the 4R Act[4] narrowed our authority under 49 U.S.C. 11341 to exempt the approved transaction from the operations of other laws such as the Railway Labor Act (RLA).[5] Second, the labor interests argue that this exemption was not necessary for the railroads to carry out the approved transactions and that any exemption from the RLA falls outside of our authority under 49 U.S.C. 11341.

We have specifically addressed UTU and BLE's arguments concerning the scope of our jurisdiction, our ability to exempt the instant transaction from the RLA, and the extent of the exemption actually granted in these proceedings. See Finance Docket No. 30,000 (Sub-No. 18), *Denver and Rio Grande Western Railroad Company—Trackage Rights—Missouri Pacific Railroad Company—Between Pueblo, CO and Kansas City, MO* (not printed), served October 25, 1983. We specifically rely on our discussion in that decision, which was issued in response to a petition for clarification of the DRGW and MKT trackage rights filed by the same parties now before us. In that decision we concluded that, contrary to the UTU and BLE assertion, use of tenants' crews to perform tenants' work does not constitute a unilateral change in the working conditions of the landlord's employees that would fall within the purview of the RLA. Further, our jurisdiction over railroad consolidations under 49 U.S.C. 11343 is plenary and exclusive. Our approval exempts such a transaction from the requirements of all laws, including the RLA, as necessary to permit the transaction to be carried out. See *Brotherhood of Loc. Eng.* v. *Chicago & North Western Ry. Co.*, 314 F. 2d 424, 432 (8th Cir. 1963), cert. denied 375 U.S. 819 (1963). The 4R Act did not limit our authority to preempt other laws in authorizing a transaction; it sim-

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[4] The Railroad Revitalization and Regulatory Reform Act of 1976. Public Law 94-210.

[5] 45 U.S.C. 157 *et seq.*

ply specified standards for the minimum level of employee protection to be imposed in cases such as this. The Consolidation decision imposed the appropriate level of employee protection under 49 U.S.C. 11347, and that protection is the full extent of labor relations involvement in these proceedings. If an MP employee is displaced by DRGW operations, for example, he or she will receive benefits under the conditions set for in *Norfolk and Western Ry. Co.—Trackage Rights—BN*, 354 I.C.C. 605 (1978) as modified by *Mendocino Coast Ry. Inc.—Lease and Operate*, 360 I.C.C. 653, 664 (1980), which were imposed in these proceedings, *MP-UP* at pp. 621-22. That employee has no right absent a negotiated settlement to take part in the DRGW operations.

The second argument advanced by the labor interests—that the exemption of selection of forces was not necessary for implementation of the transaction and therefore could not be approved—was disposed of in the Consolidation proceeding. If the exemption was not necessary to implement the transaction as proposed, it can not now be argued that the RLA prevents implementation of the trackage rights. See *MP-UP* at p. 556, note 99.

We conclude that there is no limitation on rights of the various tenants to use their own crews in these trackage rights operations, or on our ability to finally set the terms in these proceedings.

Trackage Rights

I. *Between Pueblo and Kansas City*

A. *General.*—As part of the decision approving the UP-MP consolidation, the Commission imposed trackage rights in favor of DRGW over 619 miles of MP line between Pueblo, CO and Kansas City, KS. Finance Docket 30,000 (Sub-No. 18). The greater portion of this line is without substantial grades and has an authorized speed of 55 miles

per hour. There are 47 sidings on the line, of which 32 are over a mile long. The longest siding is 12,160 feet.

Following the decision approving the consolidation, DRGW and UP negotiated for interim and permanent terms governing DRGW's operations over the MP line required by the Consolidation decision. On November 5, 1982 an agreement was reached setting interim rental which allowed DRGW to begin operations and cleared the way for consummation of the approved consolidation.[6] DRGW has operated over trackage rights between Pueblo and Kansas City pursuant to this interim agreement since the consummation of the consolidation on December 22, 1982. However, DRGW and UP have been unable to agree on the permanent terms for trackage rights operation and have requested us to set the compensation.

B. *DRGW.*—DRGW proposes to compensate UP for its usage of MP trackage in three parts: (1) the variable costs, including standard additives, of train operations, switching, and mechanical services incurred by MP as a result of DRGW operation; (2) DRGW's allocated share, on a car-mile percentage use basis, of maintenance and operation (M&O) costs, taxes, and standard additives; and (3) interest rental of $1.58 million a year calculated by capitalizing MP's expected earnings on the Pueblo line as specifically described below. The three elements of DRGW's formula reimburse UP for, respectively, (1) its variable cost incurred as a result of DRGW operations, (2) a share of its maintenance costs including part of UP's fixed costs, and (3) a return on its investment.

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[6] Interim operations of the required trackage rights was made a condition precedent to consummation of the consolidation. *UP-MP* at 590. The terms of the interim agreement called for DRGW to pay $1.5 million a year in rental plus the costs of operation to UP. The terms of the interim agreement were approved by decision served November 24, 1982.

The methodology employed by DRGW to calculate the variable costs of operations is the standard method employed in the industry for trackage rights agreements. UP does not contest the calculation of this item.

The treatment of M&O expenses is subject to some controversy. DRGW ultimately took the position that it would reimburse UP for its ratable share of these expenses as actually incurred by MP and based upon DRGW's actual use.[7] This results in a variable annual payment for M&O expenses. In its initial petition DRGW cited an example of M&O expense reimbursement yielding a contribution to UP fixed costs of $4.8 million. UP construed this calculation to be an additional "set payment" by DRGW in addition to its interest rental described below; it interpreted the DRGW position to be that the "overhead component" of M&O expense was offered by DRGW as an additional contribution to UP not necessary to offset any additional overhead costs to be actually incurred. In its response DRGW clarified that it did not contemplate bifurcation of the fixed component of MP and M&O expenses, and considered the reimbursement of a percentage of these costs actually incurred to be the full extent of compensation for these expenses. In a subsequent Motion for Leave to File Reply and a Reply, which we will allow, filed August 2, 1983, UP argued that DRGW was opportunistically changing its position and our decision should be limited to the initial proposals of the parties. DRGW replied on August 25, 1983.

UP's argument goes only to procedural considerations, for we are charged with determining the most appropriate result in this proceeding notwithstanding the positions of the parties. See *Lamoille Valley R. Co.* v. *ICC,* 711 F.2d 295 (D.C. Cir. 1983). However, our decision is bounded by

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[7] DRGW used Rail Form A estimates of these expenses in its petition in this proceeding, but acknowledges line-specific actual costs should be the basis for this calculation.

considerations of procedural fairness and the opportunity of an opposing party to address a proposal before us. In this proceeding we specifically allowed UP to file a reply to DRGW's response, a pleading normally barred by our rules, 49 CFR 1104.13(c). There is no unfairness in our consideration of all positions advanced in this proceeding, and we will do so.

Finally, DRGW proposed calculating the third element in its compensation formula, the interest rental portion, using a capitalized earnings approach. DRGW argues that a proper rental for the Pueblo line is the value of the line to UP measured by net earnings, multiplied by MP's actual rate of return and adjusted by DRGW's percentage of use. DRGW's proposal calls for payment of $1,586,216 in interest rental to UP calculated as follows:

> 1. Divide MPC's pretax operating profit for 1979 ($262,966,000) into the market value of equity at time of merger ($998,910,000). This equals 3.8. Thus, the value of the equity was 3.8 times the pretax operating profit for 1979.
>
> 2. Develop MP's 1979 net revenues for the Pueblo-Osawatomie line of $3,473,037; for the Osawatomie to Kansas City line of $2,404,409; and for the total of the two lines of $5,877,446.
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> 3. Multiply the figures in (2) by 3.8 to give valuation to the lines equal to $13,197,540 (Pueblo-Osawatomie); $9,136,754 (Osawatomie-Kansas City); and $22,334,294 (total).
>
> 4. Develop a rate of return by taking a 9.33 percent after-tax return for MP for 1979 and calculate a pretax rate of return of 11.38 percent using the MP's 1979 effective tax rate (18 percent).
>
> 5. Multiply the results in (3) by the 11.38 percent rate of return to produce interest (for 100 percent use) of $1,501,880 for Pueblo-Osawatomie and $1,039,763 for Osowatomie-Kansas City.

6. Apply DRGW usage factors to these numbers to produce interest rental of $1,201,504 for Pueblo to Osawatomie (80 percent usage); $384,712 for Osawatomie to Kansas City (37 percent usage); and $1,586,216 total.

The DRGW procedure is more specifically described in appendix A.

UP did not dispute the basic concept underlying DRGW's calculations but did argue for the inclusion of assumed liabilities of MPC ($1,361,814,000) as part of the purchase price, for a total of $2,360,724,000.[8] Inclusion of MPC liabilities as part of the purchase price results in a change in the earnings multiple of 3.8 used by DRGW to a multiple of 9.0 proposed by UP. UP also argues for the use of the statutory, not the effective, tax rate in the computation of the rate of return element. Applying these changes to the DRGW's figures produces the following:

1. Valuation of Pueblo-Osawatomie equals $31,257,657; Osawatomie to Kansas City equals $21,639,681; total equals $52,897,338.

2. Pretax rate of return at the statutory tax rate (48 percent, including 2 percent for State tax) equals 17.94 percent.

3. Multiplying the results in (1) by the 17.94 percent rate produces interest rental (for 100 percent usage) equal to $5,607,624 for Pueblo to Osawatomie and $3,882,159 for Osawatomie to Kansas City.

4. Utilizing the DRGW's usage factors produces interest rental of $4,486,099 for Pueblo to

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[8] DRGW argues that if liabilities are included in the purchase price for this calculation, then the value of MP's equipment should be excluded.

Osawatomie; $1,436,399 for Osawatomie to Kansas City; and $5,922,498 total.[9]

Finally, UP attacks the estimate of traffic on the line which DRGW used to determine the line specific earnings. DRGW assumed that 3 years after consummation of the consolidation, rerouting of traffic would divert all MP traffic except that originating or terminating on the line and a minimal amount of traffic interchanged at Pueblo between DRGW and MP which neither carrier could divert from the other. UP offers four specific categories of traffic allegedly increasing MP's traffic and revenue over the Pueblo line:

(1) Unit coal train movements originated on DRGW and interchanged at Pueblo contribute significant revenues. UP lists movements to Daniel, MS, Federal, IL, and Metropolis, IL as examples. However, in reply DRGW notes that shippers in each of these accounts have changed the junction in favor of DRGW—to Kansas City on the Federal and Metropolis movements and to Osawatomie on the Daniels movement—leaving only a 55-mile haul in the MP account.

(2) Movements between exclusive DRGW points and points in MP served States such as Arkansas and Louisiana constitute the second category. A 16-percent decline was registered for this traffic between the first 7 months of 1982 and the first 7 months of 1983.

(3) On traffic from DRGW points through St. Louis, the third category, the year to year 7-month decline was 25 percent.

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[9] The $5,922,498 figure was calculated from the data given. UP's calculation was slightly lower ($5,909,291). This difference was due to the way in which UP compared the effective and statutory tax rate adjustments.

(4) A final significant category is traffic between western points on SP and MP points. However, the Pueblo line year to year 7-month decline for this traffic totalled 74.8 percent.

C. *UP.*—In its separate submission, UP also proposes to fix the compensation due from DRGW in three parts: (1) variable costs of operations, (2) allocated share of M&O expenses, but including half of the taxes attributable to the line, and (3) an interest rental of 50 percent of the ownership costs of the line. Ownership costs for this purpose are defined as the value of the line, calculated as the reproduction cost new less depreciation (RCNLD), multiplied by an appropriate rate of return.

UP conducted a study of the Pueblo line and concluded that (1) the appraised value of real estate on the line is $14,555,790,[10] (2) the value of existing facilities is $219,685,299,[11] and (3) the total value of the Pueblo line is $234,241,089. The value for grading along the line, included within the figure for existing facilities, is $65,879,530 without depreciation adjustment. If grading were depreciated 75 percent, the total value of the line would be $184,831,422. UP considers the range of value of the line to be $184,831,422 to $234,241,089.

UP does not offer a specific rate of return to be applied to its calculated value. Rather, it suggests that a number of guidelines might be appropriate including the railroad cost of capital (1981 determination—16.5 percent) and MP's pretax return on net investment (1981—15.3 percent using the statutory tax rate).

Ultimately, UP selects $10 million as an appropriate interest rental payment for the Pueblo line and works

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[10] This figure does not reflect any assemblage premium. Including such a premium would result in a real estate value of $30,064,934.

[11] This figure represents a total reproduction cost for existing facilities of $372,883,699 less depreciation of $153,198,400.

backwards through its RCNLD approach to show that the rental is justified. Using the lower end of the valuation range ($184,831,442), the $10 million annual rental reflects a rate of return of 10.8 percent. UP notes that this rate of return is less than MP's pretax return on net investment and below the rate of return used by DRGW in its calculations. UP suggests that such a result is justified for the Pueblo line because, while a high quality line of considerable length, it does not have the strategic importance to UP that characterizes the Kansas City to St. Louis lines. UP also notes that the Pueblo line trackage rights involve a significant market extension for DRGW with corresponding risks justifying a lower valuation and rate of return.

DRGW argues that UP conceded the correctness of its earnings multiple approach and that we should not consider the RCNLD methodology. Additionally, DRGW argues that fixing interest rental at the level of $10 million a year would render its service noncompetitive and defeat the purpose of the trackage rights. DRGW offers the following annualized pro forma income statement to illustrate the asserted anticompetitive result of the proposed $10 million rental. It reflects actual revenues and line specific expenses experienced in operating the Pueblo line trackage rights during late 1982 and part of 1983 and gives effect to UP's proposed $10 million annual interest rental and UP's $5 million estimate of 1982 M&O expenses.

Pro forma income statement based on 1982-83 traffic levels, revenues and expenses (Millions of Dollars)

Operating revenues	$43.9
Train operating cost	$32.7
Maintenance and operations	5.0
Interest rental	10.0
Operating profit (loss)	($3.8)

D. *Discussion.*—We adopt the earnings multiple approach as the most appropriate technique of valuing the railroad assets at issue in this proceeding. This technique has been utilized in a number of contexts to value rail assets. See *New Haven Inclusion Cases*, 399 U.S. 392, 436-482 (1970) and *Ecker* v. *Western Pac. R.R. Corporation*, 318 U.S. 448 (1943). A similar approach to valuation was also employed in the primary consolidation proceeding to determine the fairness of the financial terms of UP's acquisition of WP stock. *UP-MP* at pp. 635-36. The decision noted at p. 635 that this method is predicated on the carrier continuing as a going-concern. This characteristic is perhaps the methodology's greatest advantage in valuing assets using in trackage rights operation. In this context, the tenant railroad will enter the property of the ongoing, owning railroad to provide competitive service where we have found that competition to be required by the public interest. The purpose of this proceeding is to set compensation for the trackage rights which will put the tenant in the same position as the owning carrier. The owning road is now using and will continue to use the asset in the conduct of its ongoing operations as a railroad. We are favoring the methodology which values the asset for this use. The RCNLD approach does not value the asset as a going-concern business, but rather solely as individual parcels of land and specific existing structures. This is not to say that RCNLD valuation is inappropriate in other contexts, or that the methodology used here is appropriate outside the immediate setting where trackage rights have been imposed to remedy anticompetitive effects of a consolidation. Where we are attempting to place the tenant in precisely the position of the owning road, however, the earnings multiple approach is more appropriate.

Fortunately we have before us a specific sale to use to construct the earnings multiple analysis—the primary consolidation transaction itself. This transaction effectively established the fair market value of MPC to UP. We

recognize that applying the earnings approach to infer the value of a specific asset involves assumptions that (1) the rate of return on investment for the corporation as a whole applies to each of its component parts in an identical manner, and (2) all assets are financed using the same mix of equity and debt as that for the corporation as a whole. Absent an exhaustive study of proprietary data, no other procedure can be utilized. Notwithstanding the minimal disadvantages of these assumptions, the earnings multiple approach results in the best estimate of the fair market value of the Pueblo line in its ongoing use as a railroad. The use of this method predicated upon the actual purchase price paid by UP is especially appropriate here, for we must be particularly sensitive to this proceeding to avoid overstating the value of the subject lines. These trackage rights have been imposed to remedy anticompetitive effects of the consolidation, and the tenant must be able to operate competitively.

While we have accepted the earnings multiple methodology, we have not accepted all of the calculations relied upon in the DRGW proposal. The specific terms of the formula are discussed below.

1. ***Interest Rental.***

a. *Earnings multiple.*—The capitalized earnings approach requires the generation of a number, the earnings multiple, which relates corporate earnings to corporate value. The major issue presented in this area is whether the value of MPC used to generate the multiple should be the value of the MPC stock at the time of the consolidation ($998,910,000) or also should include the liabilities of MPC at the time of the consolidation (an additional $1,361,814,000).

We conclude that the value used to compute the earnings multiple must include the liabilities of MPC. We are attempting to estimate the value of an asset of MP. A return on investment approach using capitalized earnings

measures a return on assets acquired and financed by both debt and equity capital. While there is disagreement among the parties as to whether the liabilities of MPC were "assumed" by UP as part of the purchase, we consider that distinction irrelevant in estimating the value of MPC's assets. UP actually paid $998,910,000 for MPC's stock. The purchase price for the company's assets, on the other hand, would be the stock purchase price (equity) plus all outstanding MPC debt on the date the company's stock was purchased, a total of $2,360,724,000.

We note that this total value figure represents the price paid for MPC assets at the time of the consummation of the consolidation—1982. It is not significant that the value is stated in 1982 dollars and that other operational factors used in the formula (*i.e.* line specific earnings) are expressed in 1979 figures. These items are not directly comparable, for the 1982 value is used only to create a single abstract number, the multiple, which relates earnings to value. However, it is critical that the figures used to generate the multiple be comparable. The use of values of equity and debt expressed in 1982 dollars in comparison with MPC earnings expressed in 1979 dollars, as proposed by UP, is inappropriate. We will instead use MPC's 1979 earnings. This is the base year for the primary consolidation proceeding, the last year prior to the announcement of the consolidation, and the year's results which formed the basis of the investment decision. Updating the nominal 1979 earnings to compare with the expression of value in 1982 dollars also avoids the distortions of the recent recession. Thus, we have converted the 1979 earnings dollars to 1982 dollars using the Gross National Product Deflator issued by the Department of Commerce Bureau of Labor Statistics.[12] This results in the nominal 1979 dollars of earnings being increased by 26.805 percent.

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[12] Other indices, such as the Consumer Price Index (CPI) or the Railroad Freight Price Index could have been used. However, we con-

Another significant change was made in the earnings calculations. The parties utilized only operating earnings for the MPC. The equity and liabilities assumed, however, financed all of the assets owned by the MPC. Many of these assets produced earnings classified as nonoperating income. In order to establish an earnings multiple for the entire corporation, we included both the operating income and the nonoperating income in our calculations.[13] The exclusion of this nonoperating income would result in a multiple that overstates the value of these lines.

Finally, we are interested in valuing the rail assets of the rail company. To the extent that the value of other assets of the corporation along with their attributable earnings can be excluded from the calculation, the multiple generated will more accurately reflect the relation of railroad earnings and value. One item lends itself to such exclusion. On August 10, 1983, UP announced that it had sold Mississippi River Transmission Company (MRTC), an MPC subsidiary, for $256.3 million. MRTC had 1982 earnings of $29.1 million. We will exclude MRTC's liabilities just as we included MPC liabilities. We take official notice of the liabilities of MRTC reflected in its consolidated balance sheet as of December 31, 1982 published in Moody's Public Utility Manual, 1983, Volume 2 page 5,466. The total liabilities of MRTC, less common stock, capital surplus, and retained earnings, amount of $185,443,000. The total value of MRTC assets was $441,743,000. To more accurately reflect the relation of railroad earnings and value, we will exclude both the value and the earnings of MRTC from our calculation.

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sider the GNP deflator, which measures the effect of inflation throughout the economy, more appropriate for updating the value of a diverse collection of assets than these more specialized indices.

[13] Based on nominal 1979 dollars, nonoperating income for the MP Corporation was $36,541,000. Operating income was $262,966,000. Total income in 1979 dollars is $299,507,000. In 1982 dollars, income is $379,790,000.

DRGW has argued that we should treat equipment as an extraneous asset in the same way that we have determined to treat MRTC. We cannot treat equipment values in this way, for we have no definitive earnings attributable to equipment. It is inappropriate to reduce the value component of the rates without also reducing earnings.

Total 1979 earnings before interest and taxes, expressed in 1982 dollars, less 1982 earnings of MRTC when divided into the total of the equity purchased and liabilities of MPC, less the value of MRTC, produces a multiple of 5.47. See appendix B. This is the earnings multiple we will use in our compensation calculation.

b. *Earnings of the Pueblo Line.*—While there is a dispute among the parties as to the appropriate level of traffic to be ascribed to MP on the Pueblo line, we conclude that DRGW has adequately demonstrated that the only MP traffic remaining on this line 3 years after consolidation will be originating and terminating traffic and a nominal amount of traffic interchanged with DRGW at Pueblo. UP has an alternative transcontinental line through Cheyenne and a line between Denver and Kansas City. These lines clearly make the Pueblo line largely surplus in the UP system. UP has acknowledged that the consolidation effectively has converted the Pueblo line, formally a transcontinental link for MP, to a branch line for the UP system. We accept the DRGW traffic estimates.

DRGW developed net revenues for the lien in two sections: Pueblo to Osawatomie, KS, and Osawatomie to Kansas City. These two segments were employed because the DRGW usage factors, as set forth below, are different on each segment. The development of costs for this traffic as set forth in appendix A. The 1979 net revenue was $3,473,037 for the Pueblo-Osawatomie line and $2,404,409 for the Osawatomie-Kansas City segment. The net revenues for the Osawatomie-Kansas City segment also include

net revenue from north-south traffic moving only between Kansas City and Osawatomie and not affected by the post-consolidation volume reductions.

We are using 1979 revenue figures because (1) they are compatible with other figures to be used in this calculation such as 1979 rate of return, (2) the 1979 figures formed the basis for the investment decision, and (3) 1979 was the base year adopted in the consolidation proceeding.[14] Use of 179 figures for the balance of our calculations is consistent with the practice throughout the consolidation proceeding. It also is not inconsistent with our use of 1982 figures in the calculation of the earnings multiple. As explained above the multiple is a separate and independent calculation creating a unitless number (i.e., not 1979 dollars of 1982 dollars). In calculating the multiple we converted 1979 corporate earnings to 1982 dollars to directly compare with the purchase price paid and the corporate liabilities as they existed in 1982. That calculation is internally consistent and yields a multiple that can be used independently (as a simple, unitless ratio) in an equation which is expressed wholly in terms of 1979 results—line specific earnings, tax rate, and rate of return. We departed from the use of 1979 base year figures only to incorporate liabilities into the calculation of the earnings multiple.

c. *Investment base.*—Multiplying the line specific earnings by the 5.47 earnings multiple results in valuation of the Pueblo-Osawatomie segment at $18,997,512 and of the Osawatomie-Kansas City segment at $13,152,117.

d. *Pretax return on investment.*—Both parties advocate the use of a pretax rate of return on investment for MPRR

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[14] The 1979 figures are used to determine the profitability of the traffic which MP handles on the line, not the volume of traffic. The traffic levels with which we are concerned are realized after the consolidation.

for the year 1979 in developing the rate of return for these lines under the capitalized earnings methodology. DRGW advocates the use of the actual or effective tax rate to compute this return factor. UP, on the other hand, advocates the use of the statutory tax rate. The Consolidation decision proceeding supports the use of the effective tax rate: "*** the landlord's actual rate of return on the value of its rail property should be given consideration***," *UP-MP* at p. 590. We use effective tax rates in other contexts to determine valuation of rail properties and rates of return, see 49 CFR 1152.34(b) and 1154.35(a), and we will use the effective rate in this proceeding. MP's effective tax rate in 1979 was 18 percent.

Using MP's annual report to the Commission (form R-1) and our return on investment methodology in effect since 1978, MP's after-tax return on investment was 8.37 percent. Backing out taxes at MP's effective rate yields a pretax return of 10.21 percent. This is the rate of return we utilized in our calculations.

e. *Total return on Pueblo Line.*—Multiplying the value of each line segment by the calculated 10.21 percent rate of return produces interest rental (for 100 percent usage) of $1,939,646 for the Pueblo-Osawatomie segment and $1,342,831 for the Osawatomie-Kansas City segment.

f. *DRGW usage factor.*—DRGW developed usage factors based on its percentage of total traffic on each segment. DRGW's percentage of post consolidation traffic on the Pueblo-Osawatomie segment is estimated to be 80 percent. Because additional UP traffic will move over the Osawatomie-Kansas City segment, the DRGW usage of this segment is estimated at 37 percent.

UP argues that the tenant share for purposes of calculating the interest rental portion of compensation should be considered to be 50 percent. UP considers the interest rental component of trackage rights compensation to be similar to a rental payment for the unlimited right to use

of the landlord's property; the rent itself is not variable with usage. UP argues that DRGW will acquire a right of usage which is comparable to MP's right in the property and that fairness requires a 50 percent share of the interest rental value be borne by the tenant. We disagree.

The trackage rights imposed in favor of DRGW were imposed to redress a specific competitive problem which we identified in the consolidation proposal. It is not a forced sale, or a lease, of an individual one-half interest in the line as suggested by UP. Rather, the rights we have imposed are analogous to a license in the law of property, and compensation (rental) for licenses is often described in terms of usage. We will require rental from DRGW to be computed on the basis of its expected usage in each segment of the line. For DRGW, this will result in a higher rental for the Pueblo-Osawatomie segment and a lower rental for the Osawatomie-Kansas City segment.

g. *DRGW interest rental.* Applying the estimated segment usage factors to the total return by segment calculated above yields $1,551,716 for the Pueblo-Osawatomie segment and $496,848 for the Osawatomie-Kansas City segment. The total interest rental portion of compensation for the Pueblo-Kansas City line for the estimated DRGW usage is $2,048,564.

2. ***Portion of Maintenance and Operation Expenses.***

No real dispute remains as to the treatment of M&O expenses. Both DRGW and UP agree that the most appropriate means of sharing M&O expense is to allocate a portion of the actual expense incurred by MP to DRGW on a percentage use basis. This comports with standard practice in the industry for joint facility compensation.

UP initially interpreted part of DRGW's M&O proposal to be a fixed annual contribution to the interest rental portion of the compensation. We have discussed interest rental fully and we will not impose any element of M&O

expense as a set annual payment. DRGW's obligation for M&O expenses will vary with use. This ensures that DRGW will not be obligated for greater than its proportionate share of expenses if its traffic volume does not reach expected levels. It also ensures that UP does not cross-subsidized DRGW traffic if DRGW usage exceeds expectations. Put another way, UP presently has the total obligation for the line of railroad from Pueblo to Kansas City. We will require DRGW to relieve UP of its obligation to maintain that line only to the extent of DRGW's usage of that line. This limit ensures that DRGW's traffic will be subject to the same cost structure on the Pueblo line as MP's traffic.

For the same reasons, we will also allocate State and local taxes[15] on the line to DRGW on a percentage use basis. UP argues that because it is required to hold the line open for DRGW use, the latter should be considered a half-owner for purposes of property taxes associated with the line. We disagree. UP remains the sole owner of these properties and liable for all expenses attributable to them. Our imposition of trackage rights, in this setting, does not constitute a forced sale of a share in these lines. UP remains obligated as their owner, and our calculation of interest rental reimburses it for the use of its property. All expenses are allocated strictly on a usage basis.

3. ***Variable Costs of Operation.***

No dispute exists as to these costs. DRGW will reimburse UP for all variable costs, including standard additives, of train operations, switching, and mechanical services incurred by MP as a result of DRGW operations. We approve this portion of the formula.

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[15] Taxes encompass all property and ad valorem taxes, assessments, fees and similar charges attributable to the lines.

4. *Conclusion.*

DRGW will be required to compensate UP for the use of its Pueblo-Kansas City line to the extent of (1) all variable costs, including standard additives, of train operations, switching, and mechanical services incurred by MP as a result of DRGW operations; (2) a share of MP's maintenance and operation expenses, including taxes, attributable to DRGW's percentage use of the line; and (3) interest rental, as calculated above.

We note that DRGW's proposal contemplates a fixed annual rental payment calculated with the projected usage shares. This approach varies from the MKT agreement, discussed later, which contemplates updating the interest rental payment to reflect actual usage share on a monthly basis. We have set all the other terms of the rental payment which fix UP's right to receive a certain rate of return on a certain value. It is fairer to all parties not to fix the interest rental based on projections but to allow it to vary, along with the other compensation terms, with the tenant's actual usage. This approach also comports with our characterization of the transaction as a license in DRGW rather than a lease of an individual interest in the property. For this reason, the figures given for DRGW's interest rental are examples of the payment at a given usage. The actual payment will vary with DRGW's actual usage.

II. *Between Kansas City and St. Louis*

A. General.—As part of the decision approving the UP-MP consolidation, trackage rights were imposed in favor of SSW over approximately 430 miles of MP track between Kansas City and St. Louis. The route includes 124 miles of centralized traffic control (CTC) territory between St. Louis and Jefferson City, MO, and two separate lines from Jefferson City to Kansas City. The River Subdivision line is a 157-mile single track line controlled by automatic block signals. There are 11 principal sidings on this line, the

shortest of which is 5,810 feet. The continued Sedalia Subdivision line from Jefferson CIty to Kansas City is a 149-mile single track line. Automatic block signals control 116 miles of this line and CTC controls 34 miles. The sidings on the Sedalia Subdivision are generally shorter than those on the River Subdivision, and it has a 1.4 percent controlling grade. The River Subdivision does not have substantial grades.

These trackage rights, in conjunction with DRGW's trackage rights between Pueblo and Kansas City, were designed to preserve efficient competitive alternatives for transcontinental traffic moving through the central corridor. Additionally, these rights improve the position of SP's southern corridor transcontinental route as a competitive alternative to the consolidated UP. *UP-MP*, 366 I.C.C. at pp. 586-87.

No agreement has been reached between UP and SP as to the terms and conditions to govern the trackage rights. The parties established certain interim terms allowing trackage rights operations to begin January 6, 1983, but those terms are subject to retroactive adjustment based on this decision. The effect of interim operations remains in dispute because SP has objected to the assignment of interest to the difference between the amount finally decided to be appropriate and the amounts it has paid as interim compensation. UP has proposed assessing interest at 15 percent annually on the difference beginning January 6, 1983. The interim agreement merely provides that the compensation terms which we shall determine "shall be retroactive to the date hereof."

SP chose not to enter a specific interim operating agreement and submit that agreement for our approval. Instead it will rely on a single determination of the appropriate level of compensation in this proceeding and give our determination retroactive effect. Under the terms of such an agreement, we will treat the payments ultimately deter-

mined to be due as if they were due periodically throughout SP/SSW's interim operation. The make UP/MP whole in this circumstance, interest will be allowed from the due date of each payment at a rate equal to the railroad industry's then current cost of debt.

B. *Threshold issues.*—Two threshold issues must be resolved before we address the compensation to be paid for SSW's trackage rights operations. First, a question has arisen regarding the exact scope of the rights within the St. Louis terminal. Second, a dispute exists over the extent to which, or whether, our decision granting SSW trackage rights contemplated any interchange rights on the MP lines.

1. ***Scope of Trackage Rights.***

The dispute over scope concerns whether the trackage rights within the St. Louis terminal extend to MP milepost 0.0 near the Gratiot Tower, as contended by SSW, or only to MP milepost 2.3 near Grand Avenue, as contended by UP. If the rights end at Grand Avenue, SSW's operations through St. Louis would necessary have to be conducted through the Grand Avenue interlocking plant and over tracks of the Burlington Northern Railroad Company (BN) and the Terminal Railroad Association of St. Louis (TRRA). SSW estimates that this operation would add at least $2 million per year to its cost of operating the trackage rights. If the rights extend to Gratiot Tower, SSW will have the right to operate trains through both MP's 12th Street and 23d Street yards.

UP argues that SSW did not request service to Gratiot Tower and that, accordingly, we should not approve such service as part of the trackage rights. However, UP acknowledges our authority to require SSW operations over this terminal trackage under 49 U.S.C. 11103. Should these rights be prescribed under 49 U.S.C. 11103, UP advocates the use of condemnation principles to set compensation for their use in addition to the compensation which we will

set for the trackage rights granted in response to the consolidation. Since the consolidation UP has undertaken improvements at the MP yards, chiefly the addition of a second running track around the yards, intended to improve the handling of interchange traffic. According to UP, these improvements would also enable SP/SSW to move trains through the yards without unduly congesting operations in the immediate future.

SSW acknowledges that it did not specifically include the 2.3 miles of MP line in its trackage rights operating plan,[16] and that its application did not contain specific milepost designations. However, SSW argues that it requested the right to operate over MP's Sedalia Subdivision which includes the disputed 2.3 miles of track. SSW allegedly sought to use, to the extent possible, the same lines between Kansas City and its connections in East St. Louis that MP uses.

BN filed a reply to UP's petition for clarification in this matter, arguing that UP's objection to SP operation over MP lines to Gratiot Tower is predicated on hypertechnical arguments. BN opposes the shift of SP/SSW operations from the MP lines to BN lines. BN objects to what it sees as an attempt to burden BN with the costs and obligations of conditions which should rightfully be borne by the consolidation applicants.

Trackage rights were granted SSW to enable it to provide service competitive to the consolidated UP/MP in the transcontinental central corridor. In approving the SP/SSW request the Commission anticipated that the trackage

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[16] SSW argues that it did not specifically include this trackage because at the time of its application the proposed improvements were unknown to it. SP/SSW had requested, in discovery, a list of all improvements proposed for the UP/MP system. SP Interrogatory 59, dated October 2, 1980. These improvements allegedly were not included in the UP/MP response. SP/SSW did not include the then single-track line through two yards.

rights would be operated in the most efficient manner possible. One of the most efficient routes through St. Louis is over the MP line to milepost 0.0 at Gratiot Tower. This trackage is included in the MP Sedalia Subdivision over which SP/SSW specifically sought to operate. Had the Commission been presented with the need for SSW to operate over trackage other than MP's, such as BN's track near the Grand Avenue interlocking plant, it would have been specifically addressed in the same manner that SSW operations over a portion of ATSF trackage near Kansas City were approved. *UP-MP* at pp. 586-88. We will therefore treat the SSW trackage rights as commencing at MP milepost 0.0 near Gratiot Tower and include the disputed 2.3 miles of track in the calculation of compensation addressed by this proceeding.

Finally, BN has requested that SSW be required to compensate BN for the use of the Grand Avenue interlocking plant even if SSW operates over MP lines to Gratiot Tower. The Grand Avenue interlocking plant was constructed pursuant to an 1895 agreement between MP and BN's predecessor. The purpose of the plant is to allow BN to cross MP tracks in St. Louis. The 1895 agreement contemplates MP maintaining and operating the plant for the benefit of BN and BN reimbursing MP for all costs of maintenance and operation. BN alleges that SSW operation over the plant is of substantial value to SSW and that BN's right to reimbursement should be recognized. We disagree.

SSW will operate straight through the facility on MP tracks and will not be benefited by the interlocker. The interlocker benefits only BN by enabling it to cross MP lines. SSW will operate solely on MP trackage, will stand in the shoes of MP regarding the interlocker, and should not incur an obligation to support a facility operated for the benefit of BN.

2. *Interchange Rights.*

The second threshold issue regarding the SSW trackage rights is whether the grant to SSW included the right to interchange traffic along MP's line. UP argues that SP/SSW sought only bridge rights over MP's lines and listed only Sedalia, MO as a possible interchange in its Sub-No. 16 application.[17] Thereafter an SP witness allegedly abandoned the interchange request.[18] We disagree.

SSW defined bridge trackage rights in its initial application as contemplating "only the right to bridge traffic across [MP] tracks, plus the right to interchange at intermediate points with other carriers."[19] SSW's witness did not abandon this request in admitting that no significant interchange was identified in the SP traffic study.

SSW has identified six points in Missouri at which it wishes to interchange traffic: Sedalia (MKT), Pacific (BN), Valley Park (BN), Marshall (ICG), Pleasant Hill (SSW), and Labadie (SSW). The application, approved in the consolidation decision, clearly encompassed interchange at the first four of these points. However, the dispute revolves around Labadie and Pleasant Hill. UP argues that neither of these points can be interchanges, for an interchange is defined as the transfer of cars from the account of one carrier to the account of another. See *United States* v. *Terminal Railroad Association of St. Louis*, 397 F. 2d 467, 471 (7th Cir. 1968) and *Southern Railway Co.* v. *Louisville and Nashville Railroad Co.*, 185 F. Supp. 645, 651 (W.D. KY 1960), affirmed 289 F. 2d 934 (6th Cir. 1961). This definition does not bar approval of operations at Labadie

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[17] Finance Docket No. 30,000 (Sub-No. 16), Application, Volume 1, p. 19 (January 13, 1981).

[18] Witness Owen Tr. 14066-14068.

[19] Finance Docket No. 30,000 (Sub-No. 16), Application, Volume 1, p. 4 (January 13, 1981). This language introduced the bridge rights sought in both the Sub-No. 15 and Sub-No. 16 applications.

and Pleasant Hill as "interchanges" simply because the operation after the consolidation would be between SSW over trackage rights and the same carrier on its own track. We would consider the point as an interchange point for purposes of the trackage rights if MP-SSW interchanges could have occurred at that point prior to the consolidation. Pleasant Hill appears to qualify as an interchange point. Labadie does not. The MP and SSW tracks do not meet at Labadie because they cross at different grades, and MP has never conducted interchange operations at Labadie.

SSW argues that it should be able to serve a utility plant at Labadie from the MP line over the utility's tracks. SSW's line from St. Louis connects with the utility's trackage and SSW is currently able to serve the plant from the east. It anticipates moving DRGW originated coal traffic to the utility from the west using the trackage rights we have approved. "The Commission and rail carriers in general have recognized a distinction between trackage rights for bridge purposes and trackage rights for local service on lease trackage." *Atchison, T. & S. F. Ry. Co.—Operating Agreement*, 331 I.C.C. 367, 371 (1967). Bridge rights may include interchange but are "granted upon the condition that the applicant shall not move over the joint line any traffic originating at or destined to any point thereon." *Panhandle & S. F. Ry. Co.—Construction*, 166 I.C.C. 681, 682 (1930). The operation contemplated by SSW at Labadie is local service to the utility and is outside the scope of its bridge trackage rights.

SP also argues that we may authorize its service to the plant at Labadie under 49 U.S.C. 10902. Without deciding the scope of our authority under that section we will not entertain such a request as part of this proceeding to set compensation for the use of the trackage rights granted as a condition to the UP/MP consolidation. Service to the Labadie plant was never in issue in that proceeding. We have decided the issue of the scope of SSW's trackage rights, and we will not adjudicate other issues here.

C. *Compensation*

1. *UP.*

In approaching the issue of compensation for SSW's trackage rights, UP first examines the value of the specific lines to the UP system and of the trackage rights to the SP system. Kansas City and St. Louis are both key Midwestern gateways, and MP's lines between them are of great strategic importance. UP states that the Kansas City-St. Louis lines were among the most valuable of the MP assets acquired by UP in the consolidation, and that they play a key role in realizing the benefits of the consolidation.

Further, UP argues that these lines are of extraordinary value to SP, both operationally and strategically. SP has long sought direct access between Kansas City and St. Louis in order to reduce by some 400 miles the length of its present transcontinental route between the West Coast and St. Louis (over Corsicana, TX).[20] UP alleges the operational savings accruing to SP as a result of SSW's trackage rights will exceed $60 million a year. UP alleges further benefit in the form of nonrecurring savings of $71.8 million from avoidance of track structure expenses and other expenditures on the Corsicana route.

Notwithstanding the significant operational benefits, UP argues that the greatest benefit of the trackage rights to SP is strategic: the enhancement of SP's position as a transcontinental carrier. SP, with these trackage rights, has a greater ability to attract traffic to its lines, either for single-line SP movement between the St. Louis gateway and the West Coast or in conjunction with DRGW in the central corridor.

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[20] See *St. Louis S.W. Ry.—Pur.—Rock Island (Tucumcari)*, 363 I.C.C. 223 (1980); and *Norfolk Southern Corp.—Control—Norfolk & W. Ry. Co.*, 366 I.C.C. 171 (1982).

UP advocates consideration of the great value of these lines in determining appropriate compensation for their use. UP's compensation proposal is similar to its proposal regarding the DRGW rights. It has three basic parts. First, SSW should assume all variable costs of its operation.

Second, it is argued that SP should pay a share of the M&O expenses attributable to the trackage rights lines, with that share being equal to SP's proportion of total car-miles on the lines. SP should also pay half of the taxes attributable to the lines.

Third, it is claimed that SP should make annual interest rental payments for use of the existing facilities on the lines in an amount equal to $19 million, which represents a 50-percent joint-user share of a total, fair annual return on the subject lines of $38 million.[21] UP believes that this interest rental rate best reflects the value to the lines of SP as a source of substantial, low-risk financial benefits, as well as all other pertinent factors bearing on the value of the lines and the rate of return that UP/MP should receive on that value.

Additionally, for any future new improvements[22] in the lines, UP proposes a separate annual interest rental be

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[21] UP proposes that this figure be fixed, with no indexing for inflation in subsequent years, and, correspondingly, no adjustments downward when existing facilities are removed and improvements installed. Similarly, in line with the usual practice in joint facility agreements, the rental would not be reduced to reflect year-to-year depreciation of the existing facilities, but SP would also not be charged with annual depreciation expense as an element of M&O.

[22] These are what were traditionally referred to as additions and betterments. However, for purposes of interest rental calculation, the full value of capital expenditures would be used and depreciation would be disregarded. Consequently the term "improvements" was employed to avoid the application of *Alternative Methods of Accounting for Railroad Track Structures*, 367 I.C.C. 157 (1983), in which the Commission adopted depreciation accounting to replace the traditional "betterments" approach in accounting for railroad track structures.

paid (until the new facility is itself replaced) in an amount equal to one-half of the cost of the improvement times a rate of return equal to the cost of capital for the improvement.

With respect to new improvements, UP's proposed trackage rights agreement would, among other things: (1) allow SP to require the installation of any new facility that would not have a material adverse effect on operations on the lines (subject to MP approval, which could not be unreasonably withheld), (2) entitle MP to undertake new improvements without first securing SP consent, and (3) require, as already noted, that SP pay a 50-percent share of interest rental on improvements (unless solely used by MP).

UP's proposal with regard to M&O expenses and taxes is identical to its proposal concerning the DRGW trackage rights. SP argues that all M&O expenses and taxes should be allocated on an actual use basis rather than a fixed 50 percent for the tenant, and that UP has not shown that another method is more equitable as required by the Consolidation decision at p. 589.

The area of greatest dispute, as with DRGW, is the determination of the interest rental component of compensation. UP computed the interest rental, defined as compensation to the landlord for the partial loss of the use of its assets, as the product of three terms: tenant share, asset value and rate of return.

UP again argues that the tenant obtains an unlimited right to use the landlord's property and a 50-percent share should be ascribed to SSW. SSW responds that its expected proportionate usage of the line is about 30 percent and that it has bridge rights with a right of interchange which are not equal to MP's retained right of ownership and service to all local points on the line. For these reasons, SSW seeks an allocation of interest rental on the basis of its percentage usage share.

UP conducted a study of the Kansas City-St. Louis lines and concluded that (1) the appraised value of the real estate on the line is $16,523,220,[23] (2) the value of existing facilities is $368,826,711,[24] and (3) the total value of the Kansas City-St. Louis line is $385,349,931.

SP argues that this valuation is grossly inflated.[25] It argues that the actual purchase price paid for MP by UP provides the best evidence of value and indicates that the actual value of the MP lines is substantially below book value. SP offers its own valuation which will be addressed below.

Again UP does not offer a specific rate of return which should be applied. It suggests a number of benchmark rates, as discussed previously with regard to DRGW's trackage rights. UP concludes that no single, scientific principle can govern the selection of a rate of return, and that we should be guided by the revenue adequacy objectives of the Staggers Rail Act of 1980, the realities of today's capital market and the high value and low risk of the trackage rights to SP.

UP ultimately concludes that an appropriate overall annual return figure for these lines is $38 million. A 50-percent allocation to SP/SSW results in a $19 million annual interest rental. UP argues that $19 million is a conservative rental when compared to amounts generated by

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[23] This figure does not include any assembladge premium. Including such a premium would result in a real estate value of $35,876,206.

[24] The value of improvements was calculated as RCNLD. The resulting figure represents a total reproduction cost for existing facilities of $452,589,124 less depreciation of $83,762,413. No discount for depreciation of grading was included in these figures. UP argues that no depreciation is normally charged to grading. See *Texas Midland Railroad*, 75 I.C.C. 1, 184 (1918), and that depreciation factors employed in the DRGW and MKT proceedings are justified by the special circumstances of those proceedings.

[25] SP argues first that the value must be reduced by the 75 percent grading depreciation factor, yielding a value under the UP formula of $281 million.

various possible rates of return, even when these rates are applied to a valuation reflecting a depreciation of grading by 75 percent, as shown in the following table:

SP rentals assuming 50-50 allocation, $281 million property valuation, and various return rates

Return rate	Annual rental
	million
18.2 percent Current cost of capital (1982-AAR testimony)	$25.6
16.5 percent Current cost of capital (1981-ICC determination)[1]	23.2
15.3 percent MPRR pretax return on net investment (1981)[2]	21.5
14.2 percent Cost of debt (1982-AAR testimony)	20.0
13.7 percent Cost of debt (1981-ICC determination)	19.3

[1] The first two figures would be higher if the equity component of the cost of capital were stated on a pretax basis.

[2] MP pretax rate of return was calculated using the statutory tax rate, not MP's effective tax rate.

SP cites the Consolidation at pp. 589-90 for the proposition that rates of return in this proceeding based on current cost of capital may not be reasonable. The highest rate of return in any existing trackage rights agreement between SP, UP, MP or WP is 8 percent. This rate appears in the October 1981 agreement governing SP's use of WP trackage between Lathrop and Niles Junction, CA. SP states that it does not participate in any trackage rights agreement with a rate of return greater than 8 percent. The effective rate of approximately 13.7 percent employed by UP is alleged to be manifestly unreasonable in light of the existing SP trackage rights return structure and the Commission's stated intent to preserve competition and permit SP to compete on equal terms with UP.

UP also proposes to treat new improvements in the following manner, First, MRPP may install new facilities

in its discretion. Unless such new facilities are exclusively for the use of MPRR, their cost would be placed in an Improvements Valuation Base and SP would pay a separate interest rental of them.[26] For each new facility, interest rental is calculated as one-half of the actual cost of the particular improvement, times the cost of capital at the time the improvement is made. When such a new facility is itself removed from service, interest rental payments on that facility cease, and interest rental is paid on any replacement facility.[27]

Second, SP may request a particular new facility, and it will then be installed by MPRR so long as it would not materially interfere with or hinder operations on the lines and MP approves the installation (which approval may not be unreasonably withheld). The cost of construction and maintenance of the facilities would be borne by SP, and no interest rental would be charged.

SP objects to the suggested Improvements Valuation Base on several grounds. First, the concept of a separate rental calculation at a differing interest rate for improvements is unprecedented in any trackage rights agreement to which SP is a party. In every SP trackage rights arrangement that employs an interest rental calculation, new improvements are added to the total valuation base at their current cost, and rental is payable thereon pursuant to

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[26] UP advocates the inclusion of its improvements in the St. Louis yards as the first entry in these accounts should we determine that SSW may operate to milepost 0.0 near Gratiot Tower. We have devermined that SP's trackage rights extend to Gratiot Tower. The improvements to the running track will benefit SP's operation and they should be included in the improvements valuation base as calculated, *infra*.

[27] Depreciation would be disregarded both in the Improvements Valuation Base and in the calculation of M&O expenses. Here, as with the calculation of interest rental for existing facilities. SP would neither be charged with annual depreciation as an operating expense nor credited with annual depreciation in the calculation of interest rental.

the same formula as for the existing facilities. Second, the creation of a separate improvements rental base would be virtually unworkable from an accounting standpoint. In the ensuing years, as new improvements are gradually made to the lines, the parties will be required to make separate rental calculations on each individual new improvement, creating the prospect of numerous separate rental calculations. SP argues that any reimbursement for improvements should be based on the percentage usage share and that, at least, it should retain the option to reimburse UP in advance for its share of the cost of new improvements rather than automatically including the cost in a separate valuation base.

SP also objects to UP/MP's proposed trackage rights terms that would not require SP's consent in the event of significant or major improvements (defined as those in excess of $100,000). Such consents are commonly required in major trackage rights resolved through the arbitration mechanism provided in the proposed agreement.

2. ***SP/SSW.***

SP/SSW proposes to reimburse UP for (1) the variable costs of operation; (2) its percentage usage share of taxes, assessments and M&O expenses; and (3) rental based upon SSW's percentage usage share, on a car-mileage basis, of 4 percent per year of the ledger value of the line plus subsequent additoins and betterments.

SP/SSW's offer is based on existing agreements between SSW and MP covering SSW's use of MP trackage between Valley Junction, IL and North Junction, IL; and MP's use of SSW trackage between Illmo, MO and Paragould, AR (collectively the Illmo agreements). The Illmo agreements cover the lines south of East St. Louis, IL, for a distance of approximately 230 miles. These lines form a significant part of SP/SSW's Corsicana route.

Using a ledger value of $68.2 million for the Kansas City-St. Louis lines and an SP/SSW usage share of 30 percent, the interest rental portion of SP/SSW's compensation formula would amount to $820,000 annually.

SP/SSW argues that a substantial portion of the traffic moving over the trackage rights will be traffic shifted from its Corsicana route, and that, therefore, it is appropriate to employ the terms of the Illmo agreements in setting terms for the new trackage rights.

UP argues that the terms of the Illmo agreements provide no basis for calculating the terms appropriate for the instant trackage rights because those agreements are reciprocal agreements. Originally negotiated in 1904 and renewed in 1954, they involve SSW use miles of MP track and MP use of 110 miles of SSW track. The primary consideration passing between the parties—the exchange of reciprocal operating rights allowing each party to avoid building additional tracks—is reflected in the interest rental terms.

UP argues that the Illmo agreements actually support its proposal to use an RCNLD methodology ad current cost of capital. The terms of the agreements were derived from the cost of constructing the Valley Junction-North Junction line, completed November 1, 1903 for $35,000 a mile, and the actual 4 percent coupon rate on the bonds used to raise capital for its construction. UP concludes that the Illmo agreements provide no support for the terms proposed by SP/SSW in this proceeding.

UP also objects specifically to two items in the SP compensation proposal. First, UP argues that the 4 percent rate of return adopted 80 years ago in different circumstances is inappropriate.

Second, UP objects to the use of book value of its lines, or book value weights in reducing the price paid for MPC

to line-specific value,[28] as the valuation used in this proceeding because book values of rail assets bear no fixed relationship to their real economic values. First, because of betterment accounting, book value weights significantly overstate the relative share of MP's total assets attributable to equipment. Second, because book value is a function of physical improvements in place and the dates of their installation, it gives no weight to the relative strategic and economic importance of specific lines. UP notes that these lines are responsible for over one-third of the projected revenue gains reflected in the applicants' rail traffic diversion study and more than one-half of the new revenue estimated in the nonrail traffic study.

Finally, the SP/SSW proposal would require SSW's concurrence prior to any major improvement of the line. SP/SSW acknowledges that it would not refuse to concur in necessary improvements to the line. UP responds that such a veto power in SP/SSW is unnecessary in light of its undeniable motive to avoid unnecessary expenditures.

3. ***Discussion.***

The decision authorizing the consolidation stated that "[v]aluation of the property should be the current fair market value, rather than book value or replacement value." *UP-MP* at p. 589. Neither SP not UP has convincingly shown that we should accept their valuation methods based respectively on book value and replacement

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[28] As support for its use of MP's ledger value for the Kansas City-St. Louis line, SP calculaetd interest rental compensation using five different formulae all reaching valuations less than ledger value. Each of these methodologies was, in one way or another, based on book value. One of them purported to allocate the actual purchase price paid for MPC on the basis of the relative book values of specific MP assets. Using this method, SP concludes that the value of these lines is $54.6 million. The result of this calculation is argued to justify SP's use of ledger value notwithstanding the admonition that "[v]aluation *** should be the current fair market value, rather than book value ***" *UP-MP* at p. 589.

value. We have already discussed the drawbacks of UP's RCNLD approach with regard to the DRGW trackage rights. The RCNLD approach does not value the asset as going-concern business, but solely as individual parcels of land and specific existing structures. Thus it ignores a characteristic vital to this proceeding: an asset's income producing potential.

The book value approach, either by direct use of ledger values as proposed by SP/SSW or through use of book value weighting of the purchase price, suffers from all of the same infirmities as the RCNLD approach with one addition: time. The ledger value simply reflects the cost of a given asset like the RNCLD approach, but the cost at a past time. Those historical costs arose at different times, in different markets, and should not be relied upon as an accurate indication of present value or as an accurate method of apportioning present value.

We find the SP's reliance on the Illmo agreements for rate of return particularly misplaced. An 80-year-old rate of return negotiated in a context of reciprocal trackage rights is wholly inappropriate here. The relatoin of these agreements to SP/SSW's Corsicana route is irrelevant. The cost structure of the SP system outside of these particular trackage rights is as irrelevant to our consideration here as is the value of these rights to the SP.

UP/MP has argued that we should consider the value of the trackage rights to SP in determining the valuation of the property. Such consideration are appropriate in determining the reasonableness of trackage rights terms in privately negotiated agreements. However, value to the tenant should not be determinative in calculating rental when trackage rights have been imposed by this agency to ameliorate the anticompetitive effects of a consolidation. We will not allow the consolidated UP/MP system to defeat that competition by extracting rents for these lines that reflect the value of SP/SSW operations. We have already

specifically rejected this theory during the discovery phase of this proceeding[29] and we reaffirm that rejection here.

We have determined that the most appropriate method of determining the value of the Pueblo line is the capitalized earnings approach applied by DRGW. We will apply the same methodology to the valuation of the Kansas City-St. Louis lines. All factors in the capitalized earnings calculation described above will remain the same except the usage share and the net revenues on the line. SP has suggested that their usage share for the line will be 30 percent. However, no figure for the net revenues of these lines are now before us. We will, therefore, require that both SP and UP prepare and submit calculations developed from the earnings multiple methodology and based on line-specific net revenues. Information necessary for making these calculations may not presently be available to SP. We except UP to cooperate in its expeditious discovery.[30] We are aware that using the earnings multiple approach on these lines reflects the strategic value of the facilities to UP through the higher net revenues attributable to these lines as a result of consolidated operations.[31] This will result in a higher post-consolidation valuation. However, the increase in UP traffic will also result in a lower SP usage share and these effects will, to some degree, offset. Nonetheless, we remain concerned that SP be able to operat with a cost structure competitive to that of the

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[29] Finance Docket No. 30,000 (Sub-No. 16) *St. Louis Southwestern Railway Company—Trackage Rights Over Missouri Pacific Railway COmpany—Kansas City to St. Louis* (not printed), decision served April 25, 1983, at sheet 2.

[30] To the extent that proprietary information may be involved, aggregate figures, averages or any other appropriate techniques may be used to make these calculations.

[31] As noted above, the Kansas City-St. Louis lines are alleged to be responsible for over one-third of the projected revenue gains reflected in applicants' rail traffic diversion study and over one-half of the new revenue estimated in the nonrail traffic study.

UP on these lines[32] As a point of reference for our review of these costs, we will also require each carrier to submit calculations using the net revenue generated on these lines during 1979, MP's last year of operation before announcement of the consolidation. This is the base period for the consolidation proceeding and the information should be readily available.

Actual net revenues should be developed where possible, or fully allocated costs may be developed using Rail Form A. For overhead traffic, revenues should be allocated to the line on a mileage prorate basis.

The required calculations should be submitted as soon as possible, but not later than 60 days after service of this decision.

With regard to improvements on the lines, we will not require UP to obtain SP consent prior to making improvements. In light of UP's incentive not to undertake unnecessary improvements, we see little possibility of abuse. However, we retain continuing jurisdiction in this matter, and, should difficulties arise, SP may seek relief from the Commission. Accounting for the interet rental on improvements should be undertaken using a separate Improvements Valuation Base. This account should be generated using the actual cost of the new improvement multiplied by the actual UP cost of capital at the time the improvement is made and by SP's usage share. SP also must have the option to reimburse UP in advance for its share of the cost of new improvements rather than including the cost in a separate valuation base.

Finally, the parties are directed to compute interest on the difference between payments under the interim op-

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[32] The premise of using the earnings multiple approach is that it reflects what UP actually paid for particular assets of the MP system based upon the earnings potential of those assets. Historic MP cost on these lines is less relevant.

erating agreement and compensation due as a result of our action here in the manner described above.

III. *Between Kansas City and Omaha/Council Bluffs*

As a condition to the consolidation, the Commission also granted trackage rights to MKT over Mp's lines between Kansas City and Omaha, NE; between Union and Lincoln, NE; and over UP's lines between Omaha and Council Bluffs, IA and between Kansas City and Topeka, KS, with use of related terminal facilities.

On November 9, 1982, MKT entered agreements with both UP and MP, then separate corporations, setting the terms of operation and the compensation for these trackage rights. These agreements were modified by a supplemental agreement entered January 21, 1983. The agreements as modified are submitted for our approval. As noted in the Consolidation decision, at p,. 589, we will approve any reasonable terms agreed to by the parties.

The agreement contemplates MKT assuming the variable cost of its operations.[33] Additionally, MKT will pay a percentage, based upon its uage share on each portion of the joint track, of M&O expenses plus standard additives and of taxes and assessments. Finally, interest rental will be determined by multiplying MKT's usage share on each portion of the joint facility by the following amounts:

	Gillmore Jct.-Co. Bluffs	Topeka-Kansas City
First 6 months (December 22, 1982 to July 1, 1983).....	$775,000	$930.000
Second 7 months (July 1, 1983 to February 1, 1984).....	2,305,000	3,014,000
Second year		

[33] The agreement requires UP/MP to conduct studies of the actual cost of switching services on the joint track and to bill MKT accordingly.

(February 1, 1984 to February 1, 1985)	4,610,000	6,028,000
Third and succeeding years	6,500,000	8,500,000

Calculation of the interest rental for the third and succeeding years is based on the reproduction cost new less depreciation of the track, track structure, grading,[34] roadbed, signal and communications facilities, and other appurtenant facilities on each portion of the joint track. The RCNLD value is then multiplied by the 1981 pretax rate of return of Pacific Rail Systems, Inc. (Pacific), the holding company controlling the railroads, of 14.23 percent.

Usage share is calculated as the ratio of tenants' gross-ton-miles to total gross-ton-miles of all users. All payments are to be made monthly in advance.

UP has reserved the right to make improvements to the trackage without the prior approval of MKT. The cost of any improvements will be added to a separate Improvements Valuation Base. Interest rental for each improvement will be calculated using actual cost, Pacific's pretax cost of capital at the time the improvement is completed, and MKT's usage share based on the gross-ton-miles ratio.

The terms agreed to by UP/MP and MKT are reasonable and will be approved.

Findings

The calculation of compensation and the terms of trackage rights agreed to by UP/MP and MKT are reasonable and will be approved.

Compensation for the DRGW and SP/SSW trackage rights should be determined in three parts: (1) the variable

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[34] Grading was depreciated 75 percent to reflect a variety of negotiating factors.

cost of operation including standard additives, (2) a proportionate share of maintenance and operations expenses and of taxes and assessments based on the tenant's usage of the facility, and (3) an interest rental calculated using an earnings multiple approach as set forth in the decision.

Neither DRGW nor SP/SSW shall have the right of prior approval of improvements on the lines of UP or MP. Compensation for improvements will be determined using a separate improvements valuation base account. Compensation for improvements should be based on the actual cost of the improvement times the landlord's then-current cost of capital times the tenant's usage share for each improvement. However, each tenant will have the option to reimburse the landlord for a portion of the construction expense based upon its usage share of the facility at the time of construction rather than increasing the improvements valuation base.

SP/SSW's application contemplated trackage rights extending to MP milepost 0.0 in St. Louis, and compensation for the St. Louis terminal trackage will be included in the overall compensation formula. SP/SSW was granted the right to interchange traffic with other carriers at points on the MP line. However, Labadie, MO, is not an interchange point and SP/SSW does not have the right to serve local industry at Labadie from the MP line even though it may serve those industries from its own line.

This decision will not significantly affect either the quality of the human environment or energy conservation.

It is ordered.

1. In Finance Docket No. 30,000 (Sub-No. 25), the agreements dated November 9, 1982 as supplemented January 21, 1983 between Missouri-Kansas-Texas Railroad Company and Union Pacific Railroad Company and Missouri Pacific Railroad Company are approved.

2. In Finance Docket No. 30,000 (Sub-No. 18), trackage rights compensation will be determined in three parts: (a) variable cost of operations, (b) a percentage share of maintenance and operations expenses and of taxes and assessments based on tenant's actual usage, and (c) an interest rental determined by the capitalized earnings approach set forth in the decision.

3. The trackage rights granted in F.D. No. 30,000 (Sub-No. 16) include operations to Missouri Pacific Railroad Company milepost 0.0 in St. Louis and the right to interchange traffic at points on the line.

4. In F.D. No. 30,000 (Sub-No. 16), compensation will be calculated in the same manner as described for the rights in F.D. No. 30,000 (Sub-No. 18). The record will be kept open for 60 days from the date of service of this decision for the parties to file appropriate information for the calculation of the interest rental component as described in the decision.

5. The difference between the compensation amounts finally determined in F.D. No. 30,000 (Sub-No. 16) and those actually paid for interim operations will bear interest at a rate equal to the railroad industry's then-current cost of debt.

6. This decision is effective on August 30, 1984.

By the Commission, Chairman Taylor, Vice Chairman Andre, Commissioners Sterrett and Gradison. Chairman Taylor was absent and did not participate.

APPENDIX A

DRGW Interest Rental Calculation

After the consolidation has been in place for 3 years, rerouting of traffic will substantially reduce UP/MP's volume on the Pueblo-Kansas City line. DRGW assumed all that will remain will be traffic originating or terminating on the line and a minimal amount of traffic interchanged be-

tween MP and DRGW at Pueblo, which neither carrier could divert from the other. This will reduce the gross tonnage between Pueblo and Osawatomie, KS, from 15.4 million gross tons per mile in 1979 to approximately 3.4 million gross tons. A breakdown of this traffic is as follows:

Traffic segment	Cars	Net tons	Gross tons
DRGW-MP coal trains	5,138	498,728	827,786
DRGW-MP noncoal	7,515	379,838	861,217
Originating/terminating traffic	11,497	952,523	1,688,773
Total	24,150	1,831,089	3,377,776

The DRGW projections were based on an analysis of 1979 traffic interchanged with MP by DRGW and Mp traffic originating and terminating on the line, including revenue and cost information, from data provided to DRGW by MP. This volume will require only one train in each direction per day, as opposed to three trains in each direction per day before consolidation.

Costs associated with the traffic were develcped using 1979 MP Rail Form A unit costs. Since Rail Form A costs were used, all calculations are based on betterment accounting for track structure. These costs were determined by costing the average characteristics per car for the three traffic segments as they would have been handled in 1979 at the reduced volume.

Certain modifications to Rail Form A were made to measure the costs more accurately. These modifications were designed to reflect those costs appropriate for inclusion in a pro forma income statement. The costs do not include the cost of capital components—return on road property and return on equipment.

Car costs were based on the average car-hire rate paid by DRGW on foreign railroad owned cars.[1] These rates were developed for each of the Ex Parte No. 334 car type classifications. Empty return ratios were assumed to be 100 percent. A tare weight of 32 tons per car was used.

Interchange switching costs and inter- and intra-train switching costs were computed on an estimated occurence basis.

Loss and damage expenses were computed on a net ton-mile basis. Costs were developed by 5 digit STCC number from actual 1979 DRGW claim payments.

Individual per car costing was initially done at the variable cost level. However, to estimate more accurately the costs associated with the traffic. MP fully allocated costs were also calculated using the ton/ton-mile method of estimating constant costs. Per car costs were multipled by the number of cars in each segment to develop total fully allocated costs. Since the MP Form A unit costs excluded depreciation, the fully allocated costs were adjusted accordingly. The methodology is similar to that employed in Finance Docket No. 30,000.

The following table sets form the development of the costs relied upon by DRGW and the Rail Form A core locations:

I. ***Development of car ownership costs per day or mile***

A. Railroad-Owned Cars

1. Mileage Rate x (1 + B2268) x B1175
2. Time Rate x (1 + B2268) x 24 x B1197
3. Ownership/Day = [(line 1 x B1181) + (line 2 x B1206)] (divided by) B290
4. Ownership/Mile = [(line 1 x B1180) + (line 2 x B1205)] (divided by) B74

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[1] DRGW suggests this standard is appropriate to reflect MP car cost, since the car—hire rates are uniform.

B. Rail Form A Core Locations

Core Value	Source	Description
B74	Sch. B. Col. 40, line 8	Rev. car miles, excl. pvt. cars
B290	Sch. A, Sheet 4.11, 9/ line 4	Car days switching, loading, unloading
B1175	Sch. B. Col. 34, line 8	Rev. car miles excel. pvt. cars
B1180	Sch. A. Sheet 4.10 8/ line 9	Percent car mile running
B1181	Sch. A. Sheet 4.10 8/ line 10	Percent car mile switching
B1197	Sch. B. Col. 35, line 8	Total car days
B1205	Sch. A. Sheet 4.11 9/ line 9	Percent car day running
B1206	Sch. A. Sheet 4.11 9/ line 10	Percent car day switching
B2268	Summ. 1. Col. 24, line 4, 2/ B/	General overhead

II. *Development of variable cost of movement*

A. Carload Costs:

1. Miles x GTM x lading
2. Milex x empty return x GTM x tare
3. Miles x empty return x B3186
4. Miles x empty return x ownership/mile
5. (number of O&D) x [(4 x ownership/day + B3265 + B3273 + B3187 + (lading x B3276) + (2 x B3290)]
6. Empty return x .5 x number of I/I and (X) switches x ownership/day
7. Empty return x [(B3715 x number of (X) switches) + B3716 x number I/I switches)]
8. Lading x miles x loss and damage cost per net ton mile

NOTE: (1) I/I = Intertrain and Intratrain; (X) = Interchange; empty return = (1.0 + empty return ratio)

(2) GTM = sume of B3261, B3262, B3263, and B3173 adjusted for number of locomotive units and training weights of trains handling each traffic segment. Way train (B3325) assumed on 20 percent of haul on traffic originating or terminating.

B. Rail Form A Sources

Core Value	Source	Description
B3173	Sch. B. Col. 9, line 12	Train Mile—Crew
B3186	Sch. B, Col. 24, line 12	TS&E—Running
B3187	Sch. B, Col. 25, line 12	TS&E—O&D
B3261	Sch. B, Col. 7, line 12	Gross ton mile
B3262	Sch. B, Col. 8, line 12	Locomotive unit mile
B3263	Sch. B, Col. 10, line 12	Train mile other
B3265	Sch. B, Col. 14, line 12	Station Clerical—CL
B3273	Sch. B, Col. 22, line 12	Spec. Svcs.—CL
B3276	Sch. B, Col. 28, line 12	Claims Clerical—CL
B3290	Sch. B, Col. 51, line 12	Switching—O&D—CL
B3325	Sch. B, Col. 7, line 19, Sht. 1.9	GTM Cost—way train
B3715	Summ. 1, Col. 3, line 3, 5/	Switching—Interchange
B3716	Summ. 1, Col. 4, line 3, 5/	Switching—I/I

III. *Development of fully allocated costs*

A. Constant cost related to distance (per ton mile) (B3393) and unrelated to distance (per ton) (B3395) calculated on a per car basis for each traffic segment.

B. Constant costs per par added to variable cost per car to develop fully allocated cost per car. Fully allocated cost per car multiplied by total cars in each segment to arrive at total fully allocated cost.

IV. ***Adjustment of fully allocated costs to include depreciation***

A. MP 1979 depreciation from R-1 = $62,144,000.

B. Total operating expense, excluding depreciation from MP 1979 Form A (B2364) = $1,162,519,000.

C. Ratio to increase fully allocated cost to include depreciation = 1.053 [(A divided B) + 1]).

D. Multiply ratio in C by fully allocated cost to develop total operating expenses associted with traffic.

By deducting the fully allocated costs from the revenues on each of the three traffic segments described above, DRGW developed the estimated net revenues attributed to the reduced traffic between Pueblo and Kansas City. The net revenues were pro-rated between the Pueblo-Osawatomie and Osawatomie-Kansas City segments on a mileage basis.

Net revenues on north-south traffic moving only between Osawatomie and Kansas City and not affected by the volume reductions were added to that line segment to develop total net revenues for each of the two line segments.

DRGW then developed the fair market value of each line segment as follows:

	Pueblo-Osawatomie	Osawatomie-Kansas City	Total
1. Operating revenue.....	$15,824,894	$1,565,100	$17,389,994
2. Operating expenses.....	12,351,857	1,221,612	13,573,470
3. Net revenues.....	$3,473,037	$ 343,487	$ 3,816,524
4. Additional traffic (1)....	—	$2,060,922	—
5. Total net revenues.....	$ 3,473,037	$2,404,409	$ 5,877,446
6. Fair market value (2)..	$13,197,540	$9,136,754	$22,334,294

(1) In 1979 north-south traffic moving only between Osawatomie and Kansas City amounted to 10.8 million net tons, based on MP density

chart. This is 6 times projected 1.8 million net tons moving between Pueblo and Kansas City. Line 3 ($343,487) x 6 = $2,060,922, estimated net revenues on north-south traffic.

(2) Line 5 values x 3.8 which represents earnings multiple ($998,910,000 market value divided by $262,966,000 MPC 1979 pretax operating profit).

DRGW developed its rate of return using MPRR's 1979 after-tax return of 9.33 percent on its net investment in railroad property. ICC Bureau of Accts. Class I Line-Haul Railroads' Selected Earnings Data for 12-Months ending December 31, 1980 and 1979. This is an after-tax rate of return which, when converted to a pretax rate of return by dividing 9.33 percent by .82 (1 — 0.18, MP's effective 1979 tax rate) yields a pretax rate of return of 11.38 percent.

The following table sets forth DRGW's ultimate calculation of the interest rental portions of compensation appropriate for the Pueblo-Kansas City line:

	Pueblo-Osawatomie	Osawatomie-Kansas City
1. Fair market value based on earnings multiple.....	$13,197,540	$9,136,754
2. Rental rate.....	.1138	.1138
3. Interest rental for 100 percent use (L.1 x L.2)	1,501,880	1,039,763
4. Rio Grande's portion of total traffic.....	0.8	0.37
5. Rental per segment (L.3 x L.4).....	1,201,504	384,712

The proposed combined rental of the two segments is $1,586,216.

APPENDIX B

I.C.C. earnings multiple calculation of initial interest rental for MP line between Pueblo, CO, and Kansas City, MO

I. DEVELOPMENT OF EARNINGS MULTIPLE

MPC Value

1982 MPC stock price	$998,910,000	
1982 MPC liabilities	$1,361,814,000	
Total 1982 MPC value		$2,360,724,000
1983 MRTC stock price	256,300,000	
1982 MRTC liabilities	185,443,000	
Total 1982 MRTC value		— 441,743,000
Total 1982 value		$1,918,981,000

MPC Earnings

1979 MPC operating earnings	$262,966,000	
1979 MPC nonoperating income	36,541,000	
Total 1979 income before interest and taxes		$299,507,000
Times GNP Deflator		x 1.26805
MPC earnings expressed in 1982 dollars		379,790,000
1982 MRTC earnings		-29,100,000
Total earnings expressed in 1982 dollars		350,690,000

Earnings Multiple

Total 1982 value	$1,918,981,000
Total earnings expressed in 1982 dollars	÷ 351,197,000
Earnings multiple	5.47

II. RATE OF RETURN

CC ROI using MP 1979 R-1		8.37 percent
1-0.18 (MP's 1979 effective tax rate)	÷	0.82
		10.21 percent

III. INTEREST RENTAL

	Pueblo to Osawatomie	*Osawatomie to Kansas City*
1979 earnings	*$3,473,037*	*$2,404,409*
Earnings multiple	x 5.47	x 5.47
Valuation of investment base	18,997,512	13,152,117
1979 pretax ROI	0.1021	0.1021
Total return	1,939,646	1,342,831
DRGW usage share	0.80	0.37
Interest rental (segment)	1,551,716	496,848
Total interest rental	$2,048,564	

INTERSTATE COMMERCE COMMISSION REPORTS

Finance Docket No. 30,000 (Sub-No.16)[1]

ST. LOUIS SOUTHWESTERN RAILWAY COMPANY—TRACKAGE RIGHTS OVER MISSOURI PACIFIC RAILROAD COMPANY—KANSAS CITY TO ST. LOUIS

TRACKAGE RIGHTS COMPENSATION

Decided December 18, 1987

The Commission is modifying the formula for setting trackage rights compensation for trackage rights in the merger decision *Union Pacific—Control—Missouri Pacific, Western Pacific,* 366 I.C.C. 459 (1982).

BACKGROUND

BY THE COMMISSION:

General. By decision in Finance Docket No. 30,000, the Commission approved the consolidation of the Union Pacific Railroad Company (UP), Missouri Pacific Railroad Corporation, Missouri Pacific Railroad Company (MP), and the Western Pacific Railroad Company (WP) under the common control of Union Pacific Corporation and Pacific Rail System, Inc. *Union Pacific—Control—Missouri Pa-*

[1] This decision also embraces Finance Docket No. 30,000 (Sub-No. 18), *Denver and Rio Grande Western Railroad Company—Trackage Rights—Missouri Pacific Railroad Company—Between Pueblo, CO and Kansas City, MO.* The previous decision in these proceedings, *St. Louis Southwestern Ry. Co.—Trackage Rights Compensation,* 1. I.C.C.2d 776 (1984), also included Finance Docket No. 30,000 (Sub-No. 25) *Missouri-Kansas-Texas Railroad Company—Trackage Rights—Missouri Pacific Railroad Company—Between Kansas City, KS and Omaha, NE.* In that decision, we approved the trackage rights agreements in Finance Docket No. 30,000 (Sub-No. 25.)

cific; Western Pacific (UP—Cont.—MP; WP), 366 I.C.C. 459 (1982) (consolidation or merger decision) *aff'd in part sub nom. Southern Pacific Transp. Co. v. I.C.C.,* 736 F.2d 708 (D.C. Cir. 1984) *(Southern Pacific).* In approving the consolidation, the Commission identified several anticompetitive effects of the transaction which could be remedied by grants of trackage rights to competing carriers.

The greatest competitive impact was noted in the central transcontinental corridor. To preserve competition in that corridor east of Denver, the Commission conditioned approval of the merger on grants of trackage rights. One grant of such rights was to the Denver Rio Grande Western Railroad Company (DRGW) between Pueblo, CO and Kansas City, MO. In another, the Commission granted the Southern Pacific Transportation Company and the St. Louis Southwestern Railway Company (collectively referred to as the SP) trackage rights between Kansas City and St. Louis. The Missouri-Kansas-Texas Railroad Company (MKT) received the third grant of trackage rights over MP's lines between Kansas City and Omaha, NE; between Union and Lincoln, NE; and over UP's lines between Omaha and Council Bluffs, IA and between Kansas City and Topeka, KS with use of related terminal facilities.

We did not set the terms of compensation for the trackage rights. We preferred that the parties agree to the terms themselves. If they did not, we stated we would set those terms. *UP—Cont.—MP; WP, supra,* at 589-590. We delineated "general principles" for just and reasonable compensation for trackage rights imposed in merger proceedings. Those principle applied to both voluntary and Commission-imposed agreements. An owning carrier was found entitled to recovery of costs and rent. Rent is based on an allocated share of return on the value of property. Valuation of the property should be based on current fair market value. Concerning rate of return we stated:

> Current cost of capital or opportunity cost may not be reasonable. In order to provide a realistic opportunity to compete, the trackage rights tenant should operate over the involved lines under economic conditions similar to the landlord's. Therefore, the landlord's actual rate of return on its properties should be given consideration in determining just and reasonable rate of return. *Id.* at 589-90.

Finally, we noted that, since the purpose of the trackage rights was to maintain a competitive balance where competition would otherwise be significantly lessened by the merger, "any terms so onerous to the tenant as to defeat the purpose of the trackage rights cannot be considered just and reasonable." (Citation omitted). *Id.* at 590.

In *Southern Pacific, supra,* the Court of Appeals affirmed the merger decision and remanded the case for reconsideration of the DRGW's request for independent ratemaking authority, an issue unrelated to these proceedings. Concerning the issue of trackage rights, the court stated that "[t]he Commission has extraordinarily broad discretion to impose protective conditions, 49 U.S.C. § 11344(c), and the courts have appropriately given the Commission's selection of such conditions great deference." (Citations omitted.) *Id.* at 721. Concerning trackage rights compensation terms, the court noted that we have instructed the railroads to negotiate acceptable terms based on the general criteria we outlined, *supra,* and that we had reserved the authority to set terms in the absence of an agreement. The court also stated:

> This procedure was entirely rational, in that the ICC specifically provided that the terms, whether agreed to or imposed, must be such as to make the new transcontinental corridor (SP/DRGW) competitive with the merged system. (Citation omitted.) * * * [W]e trust the Commission to en-

> sure that the compensation terms will not defeat the purpose of the trackage rights. The ICC has in fact guaranteed that it will see to the proper functioning of the trackage rights. (Citation omitted.) *Id.*

The MKT entered into trackage rights agreements with the UP and MP which were submitted for our approval. In our decision in this proceeding concerning trackage rights, 1 I.C.C.2d 776 (1984) (the *1984 decision* or the *trackage rights decision)* we found that the terms agreed to by the UP/MP and MKT were reasonable and were approved.[2] *Id.* at 802-04.

The DRGW and SP were unable to reach agreement with UP on the terms of compensation for the DRGW's Pueblo-Kansas City trackage rights and the SP's Kansas City-St. Louis trackage rights. They requested that we set terms. *Id.* at 779.

In the trackage rights decision, we found that the compensation should be determined in three parts: (1) the variable cost of operation including standard additives; (2) a proportionate share of maintenance and operation ex-

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[2] The trackage rights compensation agreements are set out in detail in the *1984 decision*. Generally, the MKT assumed the variable costs of its operations. Additionally, MKT was to pay a percentage, based on its usage share on each portion of the joint track, of maintenance and operation expenses plus standard additives and of taxes and assessments. Finally, interest rental was to be determined by multiplying MKT's usage share of each portion of the joint facility by specified amounts during the first two years. For the third and succeeding years, calculation of the interest rental is based on the reproduction cost now less depreciation. (RCNLD) of the track, track structure, grading, roadbed, signal and communications facilities, and other appurtenant facilities on each portion of the joint track. The RCNLD value is then multiplied by the 1981 pre-tax rate of return of Pacific Rail Systems, Inc., the holding company controlling the railroads, tat 14.23%. *St. Louis Southwestern Ry. Co.—Trackage Rights Compensation*, 1 I.C.C.2d 776, 802-804 (1984).

penses based on the tenant's usage of the facility, and (3) interest rental. *Id.* at 779-80.

There was no dispute among the parties concerning variable costs and maintenance and operation expenses. *Id.* at 790-791 and 799. The parties disagreed about the interest rental factor. We found that interest rental should be based on the tenant's usage and the MPC's 1979 pre-tax rate of return to the value of the lines. In determining value, we rejected valuation methods based on replacement costs and book value and adopted a capitalized earnings approach. *Id.* at 780.

Under this method, developed principally from a proposal by the DRGW, the earnings of the line segments were "capitalized" using an earnings multiplier derived by dividing the consideration the Union Pacific Corporation paid to acquire the MP Corporation by MP's earnings. It was assumed that all MP properties, standing alone, would yield the same return as the percentage relationship between MP's system earnings and the purchase price of the MP. Actual earnings of the particular line segment are then multiplied by the earnings multiple to arrive at an approximate value for the line segment. This figure was multiplied by the MP's pre-tax rate of return on investment to produce a total pre-tax return on investment. This amount was then multiplied by the percentage of usage of the tenant railroad (*i.e.*, the DRGW or the SP) to determine the total interest rental payment.[3] *Id.* at 786-90.

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[3] The formula adopted in our decision can be outlined in the following manner:

MP Value
÷ MP earnings
= Earnings multiplier

x MP Earnings over line segment
= Valuation of line segment

x Rate of return

Thus, the $1,918,881,000 value of the Missouri Pacific Corporation was divided by earnings of $350,690,000 to produce an earnings multiple of 5.47. The rate of return was 10.21%. For the Pueblo-Kansas City line, we computed an interest rate component of $2,045,565 based on projected usage factors for each segment of the line. *Id.* at 790. *See* Appendix A. No net revenue figures were available for the Kansas City-St. Louis line; we directed the parties to submit calculations based upon the methodology we adopted to enable us to compute the interest rental component. *Id.* at 801-802.

SP/SSW and UP/MP field supplemental evidence and replies concerning the calculation of the interest rental component for the Kansas City-St. Louis line. Petitions to reopen were filed by the SP and UP. Replies to the petitions to reopen were filed by the SP, MP, and DRGW.

Petitions to Reopen. The SP contends that the procedure developed in the *1984 decision* impedes its ability to compete with the UP. The SP asserts that the trackage rights rental formula must consider the relative elasticities of demand for the traffic carried by both railroads. The proposed methodology would force the more demand elastic traffic carried by the SP to make the same relative contribution as the less demand elastic traffic carried by the UP/MP. This would divert traffic from the SP to the UP/MP (because the more demand elastic traffic would not be priced competitively) and thus lessen competition.

The SP also alleges that the capitalized earnings methodology considerably overstates the value of the track between St. Louis and Kansas City. It argues that the book value of the line is substantially lower than the value of developed using the earnings multiplier approach. Fur-

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= Necessary earnings.

x Tenant share

= Rent

thermore, the interest rate used (10.21%) is much higher than the rate found in other trackage rights agreements, which allegedly never exceeds 8%. The SP claims that other trackage rights agreements do not use the price earnings multiplier approach, which allegedly would produce rents so high as to make the prospective tenant unable to afford the use of the trackage rights.

The SP states that the record in this proceeding establishes a more precise estimate of the value of the trackage involved. Specifically, it contends that the price agreed to by a willing buyer and willing seller in a recent purchase (*i.e.*, the UP purchasing the MP) should be used as the fair market value for the property.

Finally, the SP argues that, if the price earnings multiplier approach is used, certain adjustments need to be made to the components that are used in that methodology. It contends that the methodology should use or consider: (1) a multi-year average of both capitalized earnings and rates of return, as opposed to a single year's figures; (2) material changes, over time, in traffic patterns over the involved lines; (3) the earnings and rates of return both the landlord and tenant railroads; and (4) the type of trackage rights (bridge versus total).

The UP/MP's arguments are essentially concerned with the date used by the Commission in the rental formula, as opposed to the use of the formula itself.[4] They contend that the Commission should have used an earnings multiple based on 1979 data rather than 1982 data. Moreover, they argue that the Commission's restatement of 1979 figures

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[4] UP/MP state that they reserve the right to seek judicial review of all parts of our decision. The purpose of their petition to reopen, they say, is to demonstrate errors in our application of the capitalized earnings approach. UP/MP Petition, at 3 and 13. The DRGW also states that it reserves the right to seek judicial review if we should decide to reopen and change our *1984 decision*. Reply to Petitions to Reopen, at 15, fn. 10.

to 1982 levels had certain flaws. The Mississippi River Transportation Corporation (MRTC) earnings figure used by the Commission is alleged to be erroneous. The UP/MP concludes that earnings multiples of 83.6 or 9.73 should be used for 1979 and 1982 bases, respectively, instead of 5.47, and that the 1979 figures are preferable to 1982 figures. Finally, they contend that a 13.71% pre-tax ROI should have been used.

The DRGW in its reply to the petitions to reopen argues that the methodology the Commission prescribed must be affirmed because it strikes a reasonable balance between the desire of the landlord for interest rental and the ability of the tenant to provide competitive service. Concerning the UP/MP arguments, the DRGW states that the Commission was correct in taking into account the actual 1979 price as well as reconstructed 1982 earnings. It also contends that the Commission's treatment of the Mississippi River Transportation Corporation and our rate of return analysis was proper.

The DRGW argues that the SP has not submitted figures to prove its ability to compete will be undermined. It disputes the SP's argument that the capitalized earnings methodology is an incorrect means of valuing assets. Finally, the DRGW states the SP was afforded an opportunity to submit calculations developed from the earnings multiple methodology that are based on line specific net revenues.

PROCEDURAL MATTERS

The DRGW requests that we reject a letter from the UP/MP which seeks "to correct certain mistakes" in the DRGW's reply to the petitions to reopen. The DRGW argues that the UP/MP filing is an impermissible reply to a reply prohibited by our rules of practice. *See* 49 C.F.R. §1104.13(c). The DRGW also included a reply to the UP/MP's arguments in the event we accepted the UP/MP's

filing. The DRGW is correct in characterizing the UP/MP filing as a reply to a reply. Both the UP/MP pleading and the DRGW's reply to it will be stricken.

The DRGW also moves to strike verified statements of Gregory H. Dickinson and Gregory M. Broderick in the UP/MP petition to reopen. It argues that the UP/MP did not explain why these statements were not previously adduced as required under 49 C.F.R. §1115.3(c). Moreover, it argues that the material runs afoul of the prohibition at 49 C.F.R. §1104.8 against "any redundant, irrelevant, immaterial, impertinent, or scandalous matter. * * * ." Mr. Broderick's statement, the DRGW claims, "is not even cited in support of any arguments in the UP/MP Petition to Reopen."

We shall deny the motions to strike. Mr. Dickinson's verified statement does "not appear to be cumulative" (49 C.F.R. §1114.3) since it addresses the rate of return and earnings multiple discussion in the *1984 decision*. Mr. Broderick's statement shall also be accepted. In addresses our findings on the issue of the Pueblo-Osawatonie and Osawatonie-Kansas City line-specific earnings. It is used in the petition to reopen to support the argument that the line-specific earnings figure submitted by the DRGW and adopted by us "contain various technical errors." (UP/MP Petition to Reopen, at 17, fn. 9).

DISCUSSION

Based on the pleadings and upon our own reconsideration of the issue of trackage rights compensation, we affirm our finding that the capitalized earnings approach is the proper method of determining the interest rental component. However, we find that each part of the for-

mula should be modified,[5] including: (1) use of railroad earnings and market value investment instead of total MP corporation earnings; (2) use of 1979 data, not adjusted to 1982 levels; (3) use of a multiplier based only on the market value of roadway property and not based also on equipment; and (4) use of pre-tax current cost of capital instead of the railroad's actual rate of return on investment. Usage would be based on a three-year moving average. For the Kansas City to St. Louis line segment, earnings are based on bridge, not total, traffic. The net line earnings of the Pueblo to Kansas City line also needs to be reexamined.

We believe the capitalized earnings for multiplier approach is the most appropriate technique for valuing railroad assets in these proceedings. The consolidation decision stated valuation should be based on fair market value, rather than book or replacement value. *UP—Cont.—MP; WP, supra,* at 589. The capitalized earnings approach estimates the value of the lines on the basis of a contemporaneous arms-length transaction, thereby reasonably approximating the fair market value. The going concern value of a corporation has been found to be an appropriate method of valuation. *See Consolidated Rock Products v. DuBois,* 312 U.S. 510, 526 (1941); *see also trackage rights decision* at 786. In evaluating "going concern value," the "commercial value of property consists in the expectation of income from it." *Galveston, H.&S. A. Ry. v. Texas,* 210 U.S. 217, 226 (1908).

Before discussing the issues concerning the individual parts of the formula, we will address arguments about the overall capitalized earnings approach.

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[5] MP/UP argue that we should deny the SP's petition because material error has not been shown. DRGW contends that MP/UP and SP petitions should be denied for lack of "clear error." Our decision is being modified and it must be reopened to receive evidence on roadway investment and Pueblo-Kansas City net earnings.

We do not agree with the argument that the capitalized earnings grossly overstates the value of the Kansas City to St. Louis line segment. The SP contends that the book value of this line is substantially lower than the value obtained using that approach. This argument, however, ignores the fact that the purchase price or market value of a piece of investment property usually is based on the earnings potential of that property, not on the historical cost value shown on the earnings potential of that property, not on the historical cost value shown on the balance sheet. The line segments in question in these proceedings are high density main lines of the MP and thus have a higher income producing potential resulting in higher capitalized value than many of the lower density line segments.

The SP argues that the actual market value of the Kansas City-St. Louis trackage can be calculated from the total sale price. This value was determined to be $54.6 million by allocating the purchase price over book values, which results in a ratio of 80%. The ledger value of the line is multiplied by 80% to reach the net value of the Kansas City-St. Louis line. Alternatively, the SP argues that valuation could be calculated by allocating the purchase price over mainline route miles, gross-ton miles, total route miles, or projected post-merger traffic volumes. The value of the lines under these alternative methods would not exceed $54.6 million.

We must reject the book value approach of valuation. As we noted in the *trackage rights decision,* such a method "does not value the asset as a going-concern business, but solely as individual parcels of land and specific existing structures. Thus it ignores a characteristic vital to this proceeding: an asset's income-producing potential." *St. Louis Southwestern Ry. Co.—Trackage Rights Compensation,* 1 I.C.C.2d 776, 801 (1984) at 801. Moreover, this method reflects a "cost at a past time. Those historical costs arose at different times, in different markets. and

should not be relied upon as an accurate indicator of present value or as an accurate method of apportioning present value." *Id.* We prefer the capitalized earnings approach, which develops line value by taking the net earnings of the St. Louis-Kansas City line ($18,287,939 without an adjustment for incentive per diem (IPD)), *see infra* and multiplies this by an earnings multiplier based on the market value of railway property divided by net revenue from railway operations. This multiplier will be reduced when the market value of road property is determined.[6] The SP dies not explain sufficiently or adequately justify its other alternative methods of valuation.

The SP also contends that the procedure developed in the *1984 decision* impedes its ability to compete with the UP. It argues that the UP's "corrections" to the *1984 decision* would more than double the SP's rental, forcing it either to rehabilitate the former Rock Island line or use the circuitous Corsicana route. Use of that route would allegedly have an adverse impact on the environment.

In its reply statement, the SP includes a table which compares costs and net earning for the SP and MP operating over the same line. This table is reproduced below:

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[6] The market valuation for road property we are developing should be relatively close to the $54.6 million valuation advocated by the SP. As shall be discussed *infra*, the 7.74 earnings multiplier, based on the market value of both road and equipment property, will be reduced to reflect the market value of only road property. If, for example, the market value, as a percent of total road and equipment property is 43.5% (the percentage relationship on a book value basis), the resulting multiplier would be 3.37 (43.5% times 7.74) which when multiplied with the net line earnings of $18,287,939 gives a valuation of $61,630,354.

	SP	MP
Carloads	300	700
Revenues/Carload	$1,500.00	$1,500.00
Operating Costs/Carload	1,000.00	1,000.00
Revenues Minus Operating Costs	500.00	500.00
Rental/Carload (700 x $500 x 1.15 x .3/300)	402.50	0
Net Earnings/Carload	$ 97.50	$ 500.00

The 1.15 multiplier under "Rental/Carload" is derived by multiplying the UP's proposed capitalized earnings multiplier of 8.36 by the proposed UP return on investment of 13.71%. The usage factor is .3.

This table shows the SP realizing substantially less earnings than the MP. Since the operating costs are shown to be the same for both carriers, it appears that the cost of road property (including the cost of capital) has not been included. Such costs must be considered to accurately determine net earnings per carload. Some of these costs are reflected in the $402.50 rental per carload for the SP, but none of these costs are included in the MP's figures, resulting in an overstatement of MP's net earnings per carload. If the MP's costs per carload are increased to include the cost of road property (including the cost of capital) we believe that the differential between the SP and MP earnings would be substantially reduced, if not entirely eliminated.

The SP also argues that the capitalized earnings formula is flawed because a lower usage share does not necessarily result in a lower rental, as demonstrated in the following Sp examples:

	SP Cars	MP Cars	MP Earnings	Multiplier	Capitalized Value	SP share of Capitalized Value
Case 1	250	500	$ 50,000	5.5	$275,000	$ 91,667
Case 2	250	1,000	$100,000	5.5	$550,000	$110,000

This example, SP contends, shows a greater rental bill when MP's traffic increases.

The SP misconstrues the formula. The net earnings of the line, as well as the earnings multiple, is a fixed figure. An increase in line earnings will not increase the rental. Based on our modifications to the formula, the usage share will be based on a three-year rolling average and the pre-tax cost of capital will be changed annually. Thus, unless offset by a sufficient increase in the cost of capital figure, the rental would decrease when the renter's usage is lowered.

As noted, the capitalized earnings method of valuation consists of four elements: earnings multiplier, return on investment, line earnings, and usage. Although we are affirming the basic capitalized earnings methodology of the trackage rights decision, we conclude that the decision's findings concerning each element of the formula should be changed. Our discussion follows.

A. *Earnings Multiplier*

The earnings multiple is used because in theory it is assumed that all MP properties, standing alone, will yield the same return as the percentage relationship between MP's system earnings and the purchase price of the MP. Specifically, in the *1984 decision*, the MPC value was derived by subtracting the Mississippi River Transportation Corporation (MRTC) stock price and liabilities from the MPC stock price and liabilities. This amount was divided by a figure derived by adding MPC operating earnings and non-operating income, multiplying that amount by the Gross National Product Deflator issued by the Department of Commerce Bureau of Labor Statistics and subtracting MRTC earnings.

The *trackage rights decision* found a multiplier of 5.47.[7] We find two errors in our 1984 analysis: using a mixture of 1979 and "escalated" 1982 figures for the MPC value; and using after-tax earnings instead of pre-tax earnings for the MRTC. In addition, we are changing the *1984 decision's* treatment of the earnings multiplier by using 1979 railroad-only value and earnings and requesting data to determine a multiplier based only on road property.

Use of 1979 Data. Our *trackage rights decision* used 1979 data *except* in the development of the earnings multiple. *See St. Louis Southwestern Ry. Co.—Trackage Rights Compensation, supra,* at 787. For the multiplier, we stated that the $2,360,784,000 figure "represents the price paid for MPC assets at the time of the consummation of the consolidation—1982." *Id.* We did not have 1982 MP cor-

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[7] Development of earnings multiple:

MPC Value		
1982 MPC stock price	$998,910,000	
1982 MPC liabilities	$1,361,814,000	
Total 1982 MPC value		$2,360,724,000
1983 MRTC stock price	$ 256,300,000	
1982 MRTC liabilities	185,443,000	
Total 1982 MRTC value		— $441,743,000
Total 1982 value		$1,918,981,000
MPC Earnings		
1979 MPC operating earnings	$262,966,000	
1979 MPC non-operating income	36,541,000	
Total 1979 income before interest and taxes		$299,507,000
Times GNP Deflator		x 1.26805
MPC earnings expressed in 1982 dollars		379,790,000
1982 MRTC earnings		— 29,100,000
Total earnings expressed in 1982 dollars		$ 350,690,000
Earnings Multiple		
Total 1982 value		$1,918,981,000
Total earnings expressed in 1982 dollars		÷ 351,197,000
Earnings multiple		5.47

poration earnings data available at the time of our *1984 decision*. Therefore, we extrapolated 1979 MP earnings forward to 1982, using the Gross National Product Deflator. We now find that 1979 data should be used for the entire earnings multiplier analysis as well as for net earnings. As discussed, *infra*, we shall use the current cost of capital and a moving average for usage.

We erred in stating that the $2,360,784,000 was a 1982 figure. The agreement that placed the $2.36 billion value on the MPC's assets occurred on January 4, 1980. This amount was based on 1979 information concerning both the value of the consideration given and the earnings stream acquired. Thus, our *1984 decision* held this 1979 (but assumed to be 1982) valuation constant but increased earnings with the GNP deflator of 26.805% to $379,790,000. In fact, MPC's actual earnings in 1982 were only 4% above 1979 earnings—$313,131,000 compared with $299,507,000. Moreover, the $2.36 billion was not the correct 1982 valuation. UPC had agreed on January 4, 1980, that upon consolidation it would issue a set number of shares of UPC stock and assume all liabilities of MPC. When the acquisition was finally consummated on December 22, 1982, both the value of the UPC stock and the value of MPC's liabilities were significantly greater, a total of $2,888,015,000[8] or 22% greater than the amount used in the decision.

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[8] *CONSIDERATION GIVEN BY UPC FOR MPC.*

	Value On January 4, 1980	Value On December 22, 1982
8,667,327 shares of UPC common stock[b]	$ 624,048,000	$ 780,059,000
4,333,664 shares of UPC preferred stock[c]	374,862,000	424,699,000
MPC liabilities[d]	1,361,814,000	1,683,257,000
TOTAL	$2,360,724,000	$2,888,015,000

The DRGW supports the use of 1979 data for valuation but argues that actual 1979 earnings should be escalated to the 1982 level to avoid distortions attributable either to a recession or abnormally favorable results in actual 1982 earnings. Thus, the earnings multiple would take into account the price paid for MPC's future earnings stream.

We believe that a mixture of "actual" and "escalated" figures, as well as use of different years figures, is improper. If the carrier was acquiring the future earnings stream, it was also acquiring the future valuation of the other carrier. One figure cannot be held constant and the other increased. Since we now have the data for both 1979 and 1982,[9] a multiplier could be employed with the data from either year. Since there was no way to predict in 1979 the actual 1982 figures (as is evident from escalated 1982 valuation and earnings data), we believe that 1979 figures are more theoretically sound since all the terms of the merger were based on earnings and investment data as of 1979.

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[a] Figures are rounded to the nearest thousand.

[b] NYSE Composite prices on January 4, 1980, ($72 per share) and 2-for-1 split). *See UP/MP/WP*, 366 I.C.C. 459, 628 n.140.

[c] Stated value on January 4, 1980, ($86.50 per share) *(see id.)* and NYSE Composite price on December 23, 1982, the first day of trading ($98 per share).

[d] Market value of the liabilities on December 31, 1979, and December 31, 1982, as calculated by UPC's accountants in 1980 in connection with proxy statement to UPC shareholders and in 1983-1984 in connection with post-merger accounting consolidation of UPC and MPC. Dickson V.S., at 1.

[9] According to the UP/MP, using actual 1982 data would yield a higher multiplier than using 1979 data. The UP/MP contend that for 1979 the multiplier would be 8.36; for 1982 it would be 9.73. The multiplier is derived by subtracting MRTC stock price and liabilities from MPC stock price and liabilities and dividing that by a MPC before tax earnings (derived by subtracting MRTC before tax earning from MPC operating and non-operating earnings). The UP/MP's figures were derived by making adjustments to the MRTC's data. (*See* tex *infra.*)

As noted, the earnings multiplier approach employed adjusted MP Corporation earnings. An affiliate of the MP Corporation, MRTC was sold on August 10, 1983, for $256.3 million. The *1984 decision* added to this amount $185.4 million in liabilities to determine the value of the MRTC. The MRTC earnings for 1982 were subtracted from MPC earnings (*see* footnote 7). The parties all commented on these adjustments. The DRGW concluded that the adjustments were essentially correct. The SP argued that the liabilities of the MRTC should also have been considered. The UP contended that these adjustments erroneously used after-tax earning for the MRTC and book value for the 1982 liability figure. Moreover, the UP claims of the MRTC stock sold in 1983 would have to be converted to a 1979 equivalent using a price/earnings ratio.

After examining the evidence, we conclude that the MRTC earnings figure used in the original decision was erroneous. This error was due to the use of after-tax earnings for 1982 instead of 1982 pre-tax earnings.[10] Moreover, since we are using 1979 data, a proper method of determining the 1979 value, liabilities, and earnings of the MRTC would have to be developed. The MRTC issue, however, has been mooted since we are relying (*see* discussion below) solely on data for the the MP Railroad in developing an earnings multiplier. The use of railroad-only data precludes the need for any consideration of adjustments for the sale of the MRTC, and also excludes consideration of any other non-railroad assets or earnings of the MP at the time of the merger.

Use of MP Railroad Data. Although trackage rights are railroad-specific in nature, relating only to the use of track

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[10] This adjustment erroneously used after-tax earnings for the MRTC of $29,100,000. MRTC before-tax earnings for the MRTC of $56,610,000 should have been employed. With other multiplier components unchanged this correction results in the earnings multiple being increased from 5.47 to 5.94 based on MP's 1982 valuation of $1,918,000 divided by corrected 1982 MP earnings of $323,178,000.

and other related road property, the formula used in the *1984 decision* relied on an earnings multiplier model based on the earnings and market value of the entire MP Corporation. This was done because the only evidence available in the original pleadings was on a corporate basis. We found that the total value of the MP Corporation was $2,360,724,000. We subtracted from this figure the total value of the MRTC, $441,743,000. This left a net value of $1,918,981.

In its petition to reopen, the UP/MP included a market valuation of the MP Railroad as of the end of 1979, determined by their witness Gregory H. Dickinson to be $1,422,328,000. Mr. Dickinson calculated this figure in connection with the return on investment issue by comparing the book value of the MP Corporation in 1979 to the market value for the MP Corporation and restating the railroad's investment base to account for the fact that the market value of the MP Corporation was less than its book value. This figure was not disputed by the SP.

The DRGW criticized the method of arriving at the $1.422 billion figure as "simplistic" and based on "questionable assumptions."[11] We shall accept the $1.422 billion figure as the best evidence of record for the market value of the railroad. Parties may present further evidence of record for the market value of the railroad. Parties may present further evidence on this issue in support of a more accurate market valuation. The MP's market valuation is not needed to determine return on investment since we are using pre-tax cost of capital data. However, the market value will be used as the numerator in determining the earnings multiplier. This figure will be further adjusted by

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[11] It should be noted that this criticism was made in the rate of return context where the lower the valuation, the higher the return on investment and, consequently, the rental. In this instance, the lower the valuation, the lower the multiplier number and rental.

an allocation for the market value of road property (*see* following discussion).

Development of the Multiplier. The multiplier is calculated by dividing the market value of the railroad property (from Witness Dickinson) by the net revenue from railway operations (as shown in the MP's 1979 Annual Report Form R-1). This procedure produces a multiplier of 7.74.

The parties have not made an issue of the multiplier being based on a valuation derived from both road and equipment property. Since the tenant railroads would be using their own equipment, the use of a multiplier based on both road and equipment overstates the value of the railroad property to be used. For example, as reported in the 1979 Annual Report Form R-1 of the MP, road property was 43.5% of railroad property, equipment was 55.2%, and other 1.3%. Thus, a more precise multiplier would be one based only on the market value of the road property when the merger was undertaken. Since we do not have this figure, the multiplier would be one based only on the market value of the road property when the merger was undertaken. Since we do not have this figure, the multiplier cannot be developed at this time. Consequently, comments are requested concerning the value of this road property. Specifically, we are interested in the market value of that portion of the UP's consideration paid for the MP that is allocated to road property. This, in turn, will serve as the basis for developing a revised "road property only" multiplier to apply to the line segment earnings.

We have outlined below the development of the multiplier without the adjustment made for use of road property only.

Development of 1979 Multiplier

RW Op Rev	1,418,727
RW OP Exp	1,234,979
Net Rev RW Ops	183,748

Market VAl RW Prop	1,422,328
Multiplier	7.74

B. *Determine Rate of Return: Use of the Current Cost of Capital*

In the *1984 decision*, we approved the use of the actual rate of return in 1979 for the MP on a pre-tax basis (10.21%) to develop the return element for the line segment.[12] The SP supported use of the five-year pre-tax rate of return of both the landlord and tenant railroads weighted by percentage use. The SP argues that the so-called "Niles Canyon Agreement" between the SP and Western Pacific is a "state-of-the-art joint facility contract." It has an interest rate of 8%, while the prime rate at the time the agreement was executed was 19%. Moreover, the SP states that none of the hundreds of existing voluntary trackage agreements imposes an interest rate exceeding 8%. The UP/MP argue that freezing the MP's pre-tax rate of return for use in determining annual interest rental prevents the UP/MP from ever earning adequate revenues on the trackage rights lines. Instead, they argue that DRGW and SP will be cross-subsidized in their efforts to attain adequate revenues at the expense of UP/MP. Nevertheless, "accepting the Commission's basic approach for purposes of this petition," the UP/MP argue that our return on investment methodology should use in the denominator of the fraction an average net investment in railroad property based on fair market, not book, value.

We now believe that return on investment should not be applied to determine the necessary rate of return.[13]

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[12] We have defined rate of return on investment as net operating income divided by the net investment base. *See Standards for Rail Revenue Adequacy*, 364 I.C.C. 803, 821 (1981).

[13] We must also reject the SP's arguments concerning the "Niles Canyon Agreement" between SP and Western Pacific. Those trackage

Instead, the pre-tax equivalent of the current cost of capital rate for the railroad industry should be used.[14] A goal of the national rail transportation policy is to "promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Interstate Commerce Commission * * *" 49 U.S.C. §10101a(3). Congress has directed us to aid rail carriers in attaining revenues that are "adequate, under honest, economical, and efficient management to cover total operating expenses, including depreciation and obsolescence, plus a reasonable economic profit or return (or both) on capital employed in the business." 49 U.S.C. §10704(a)(2). Perpetuating, without valid reason, a return that is insufficient in the long run to allow for adequate reinvestment is not justified.

Besides the Congressional mandate, we believe there are sound practical and policy reasons for using the current cost of capital. the cost of capital rate represents the average cost to any of the railroads for obtaining capital. Its use favors no carrier over another and places both the

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rights agreements have been freely entered into by two parties who are in agreement. The Niles Canyon Agreement was an "arms-length contract" derived from hard bargaining on both sides." (SP Petition to Reopen, at 7, quoting V.S. of Thor H. Sjostrand). Furthermore, trackage rights agreements are usually reciprocal in nature, with each railroad granting the other trackage rights over their lines. In the instant proceeding, we are faced with adversary parties who are entering into trackage rights agreements not because of a mutual agreement, but as the result of the Commission's order in a consolidation proceeding. We are being asked to set trackage rights compensation due to the inability of the parties to achieve a meeting of the minds.

[14] The cost of capital includes cost of borrowed funds (interest expense) and equity capital. The current cost of capital for the Class I railroads is determined annually by the Commission. The most recent determination setting 11.7$ as the updated cost of capital was in *Railroad Cost of Capital—1986*, 3 I.C.C.2d 948 (1987). Prior years' findings are all higher. The 1986 cost of capital calculated on a pre-tax basis is 19.13%. (See discussion in text, *infra*, and Appendix B).

incumbent and tenant railroads on an identical footing regarding a required rate of return. It prevents "railroad shopping" where a carrier with a low return on investment is an attractive trackage target. It ensures that the renting carrier is not subsidized by the owning road. Moreover, the pre-tax equivalent of the industry cost of capital is used in abandonment proceedings and rate prescription proceedings in the absence of justification for some other figure. Such justification is not present on the record. *See Abandonment Regulation—Costing*, 3 I.C.C.2d 340 (1987); *Abandonment of Rail Lines—Use of Opportunity Costs*, 3 I.C.C.2d 810 (1987); *Omaha Public Power District v. BN R. Co.*, 3 I.C.C.2d 123 (1986), *aff'd*, 3 I.C.C.2d 853 (1987).

This principle was recognized in a pleading dated October 21, 1985, by the Santa Fe Southern Pacific Corporation (SFSP)[15] in Finance Docket No. 30400 *et al., Santa Fe Southern Pacific—Control—Southern Pacific Transportation Company.* Citing testimony of Dr. William Baumol, the SFSP argues that the compensation formula in our trackage rights decision is fundamentally flawed. It cirticizes different elements of the formula. In particular it supports use of the current cost of capital. To tie trackage rights compensation to the rate of return of the railroad (and an internal earnings multiple) "virtually forecloses the landlord with inadequate revenues from ever earning adequate revenues on the assets in question* * *." SFSP Initial Brief, part two, at 422. When all the landlord costs are not covered by compensation terms, "trackage rights constitute a cross subsidy from the landlord or its customers." *Id.* at 416.[16]

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[15] The SFSP is the holding company that controls the Santa Fe and owns the SP but holds it separately by virtue of a voting trust approved by the Commission. Decision in F.D. 30400 (not printed), served December 23, 1983.

[16] The SFSP also adds that trackage rights compensation should not be placed so high as to preclude the renter from providing efficient

Finally, we must determine which method should be employed for calculating the cost of capital: pre-tax or after-tax; nominal or "real",[17] statutory or effective rate. The pre-tax value should be used because all other costs associated with the trackage rights are also on a pre-tax basis and, as noted, it is employed in other proceedings. We have used the nominal instead of the real cost of capital to develop the pre-tax value since we are not changing the investment base by indexing it for inflation. If we had indexed the investment base, use of the nominal cost of capital would have resulted in a double count. For the nominal cost of capital, we are using the statutory tax rate (46% through 1986) since it places both the tenant and landlord railroads on an equal footing. The effective tax rates would differ for each of these railroads on an equal footing. The effective tax rates would differ for each of these railroads, and a determination of which one's effective tax rate should be used would have to be made. There would arise a problem similar to using a particular rate of return: the "shopping" for the best railroad as a tenant or landlord would be encouraged.[18]

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service through the exercise of the trackage rights. It states that "if trackage rights cannot be priced so that they are both fully compensatory to the landlord and low enough to enable the tenant to provide efficient service, then trackage rights should not be imposed, for it is clear that affected markets cannot support both rail competitors." *Ibid.*

[17] The nominal cost of capital is the real cost of capital including inflation. The real cost of capital is the cost of obtaining financing (debt and equity), including a risk premium, absent inflation.

[18] There is no evidence to determine what the effective tax rate would be for the line segments. The difference between the statutory and effective tax rates is due to investment tax credits (ITC) and/or timing differences between accelerated and straight line depreciation. Absent a large amount of line specific data, we cannot determine how much of either of these two elements exist. It is also likely that there is little in the way of deferred taxes associated with the ling segments due to their age and the likelihood that most of the deferred taxes for that line segment may already have been recovered. Deferred taxes and ITC's are largely related to new purchases, mainly equipment.

Appendix B to this analysis depicts our calculations for the development of the cost of capital for 1982 through 1986 on a pre-tax basis. These pre-tax rates have been developed in the same manner used in various abandonment and rate prescription cases. The cost of equity has been converted to pre-tax equivalents using the 46% statutory tax rate in effect for those years. The cost of debt is the same on both an after-tax and pre-tax basis.

C. *Line-Specific Earnings*

SP Earnings. Evidence concerning line specific earnings for the Kansas City to St. Louis track was provided by both the SP and UP/MP. The SP concluded that the MP's earnings over this line during 1979,[19] adjusted for diverted traffic, were $5,860,564. The UP/MP concluded that the MP's earnings attributable to the line segment were $38,142,667. We have analyzed the evidence and conclude that the MP's bridge traffic earnings, excluding an IPD adjustment, were $18,287,939. (*See* Appendices C and D.) We will briefly summarize the major adjustments to revenues and expenses.

Concerning the issue of bridge versus total trackage rights, we agree with the SP that we must take into account the fact that it was only granted trackage rights for bridge traffic over the Kansas City to ST. Louis line segment and that the value of bridge-only rights is lower than total traffic rights. Although SP has the right to interchange cars with other railroads at five specified points along the line, it cannot originate or terminate

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[19] We do not believe the five-year average for developing the net earnings of the line should be employed. As noted, the capitalized earnings methodology estimates the value of the lines of a contemporaneous arms-length transaction to derived a market value. The year used to determine net earnings should be the same as the earnings multiplier year (1979), the year in which the investment decision was made.

traffic at intermediate points. We do not believe it is proper to require SP to pay interest rental on rights it cannot exercise. Consequently, our analysis of the earnings of the line excludes the revenues and associated costs of the MP's local traffic. This adjustment reduces revenues by $4,060,377.

We agree with the MP that a portion of unmatched system revenues should be assigned to the corridor traffice. We assigned 12% of the system unmatched revenue figure, which increased revenues by $3,263,617. The basis for the 12% figure is discussed in Appendix C.

There were three major additions to the MP's expenses: through and way train costs; constant costs; and interchange of TOFC traffic. These adjustments and other, less significant adjustments, are also discussed in Appendix C.

The MP study assumed all carload traffic routed over the Kansas City-St. Louis line segment moved in through trains. SP modified the MP through train costs by inserting an element of way train movement. We agree with SP's adjustment, which adds approximately $2,900,000 to the MP's costs.

We also accept SP's restatement of constant costs. MP had made no distribution of fixed costs to show a fully allocated level for the post consolidation traffic. This adjustment adds $8,900,000 to MP's costs.

The interchange costs of trailers at the Mississippi crossing at St. Louis were not included by MP. We accepted the SP adjustment which increased costs by $2,500,000.

Finally, we believe that incentive per diem (IPD), where applicable, should be included in any analysis as an expense element. Nevertheless, SP's adjustment which sought to remedy MP's omission, and added $290,000 to MP's corridor expenses, is disallowed in our restatement.

The source for SP's adjustment is MP's IPD payable figure ($7,951,000) instead of $786,000, a net deficit figure

after deduction of the IPD receivables ($7,165,000). This error results in overstating the eventual IPD expense. Since $786,000 is a system deficit amount, a portion of its should be attributed to corridor operations.

We are unable to correct SP's adjustment to reflect the appropriate IPD expense from the supporting evidence on the record. Therefore, MP's line specific net earnings, as restated, reflect no allowance for IPD expense. The parties may develop evidence to identify the extent of IPD expense attributable to corridor traffic.

DRGW Earnings. The *1984 decision* developed 1979 net earnings for the Pueblo to Osawatomie Line of $3,473,037 and for the Osawatomie to Kansas City line of $2,404,409. These figures were based on evidence supplied by the DRGW. As noted, the capitalized earnings formula was based on a trackage rights compensation approach proposed by the DRGW. The other parties in the 1984 proceeding pursued alternative theories for setting interest rentals and thus did not examine in detail or challenge the supporting DRGW evidence that we accepted. Now, in its Petition to Reopen, the UP/MP allege that there were errors in the DRGW study of operating expenses, namely:

(1) The use of variable and constant costs by DRGW from a Rail Form A application was found to be flawed during the UP/MP/WP merger proceeding.

(2) A depreciation additive used by DRGW in the form of a ratio to increase fully allocated cost to include depreciation expense double counts depreciation on rolling stock. A ratio of 2.053 was developed from total depreciation expense divided by MP's total 1979 operating expenses. However, the total depreciation amount of $62,144,000 should have been reduced by $32,153,000, the amount of depreciation on freight cars; this figure had already been included in the variable cost through the use of per diem and mileage rates.

(3) The DRGW rail cost study included interest expense from car ownership costs and at the same time embraced a substantial amount of interest expense from the per diem calculation used for development of car costs for the traffic moving on the Pueblo-Kansas City segments.

(4) The DRGW study results contain a double-count of property taxes. There is property tax for MPRR cars included in Rail Form A unit costs and also in the per diem rates used as a surrogate for costs.

(5) MPRR costs as calculated by DRGW included per diem rates in effect for the latter half of 1979. These rates were applied to traffic moving in the first half of 1979 as well. The lower rates that were in effect during the first half of 1979 were not included in the calculations in the form of an average annual figure.

Based on its adjustments, the UP/MP contend that the net revenue on Pueblo-Osawatomie is $4,224,260 and on Osawatomie-Kansas City is $2,924,488.

As in the *1984 decision*, we do not have rebuttal regarding net earnings evidence on the Pueblo to Kansas City lines. The only response of record from the DRGW on this issue was to request that the evidence be stricken or disregarded, a request that we have denied. (See section on "procedural matters," *supra*.) The DRGW also filed in reply to the UP/MP letter a pleading concerning the issue of 1979 Rail Form A data. But, as also noted in our discussion of procedural matters, both the UP/MP letter and the DRGW response will be stricken. Based on the evidence before us, the elimination of the double count for depreciation and an averaging of per diem payments over a year appear to be acceptable adjustments. However, the alleged double count in interest and property tax expense requires further analysis that cannot be done on this record. We are thus reopening this proceeding to receive further evidence on the line's earnings.

D. *Usage*

We stated in our *1984 decision* that, although all other terms of the formula were fixed, the interest rental should vary with actual usage. We did not define the time period for determining usage, although we noted that the MKT agreement updated usage on a monthly basis. *St. Louis Southwestern Ry. Co.—Trackage Rights Compensation, supra,* at 791. The DRGW had submitted projected usage figures for the Pueblo-Osawatomie line and the Osawatomie-Kansas City line of 80% and 37% respectively. *Id.* at 790. SP stated in pre-*1984 decision* filings and post-*1984 decision* filings that its usage on the Kansas City-St. Louis line would be 30% and 25%, respectively.

SP has requested that we permit carriers "to adjust the rental value to reflect material changes in traffic patterns over the Kansas City-St. Louis trackage." We believe such changes can best be reflected in the usage part of the formula. We find that usage should be based on a three-year moving average to avoid extreme fluctuations in rental based on sharp increases or decreases in usage. Ideally, the usage percentage should be determined by the railroads themselves, preferably using gross-ton-miles.[20]

The use of a changing usage multi-year average has the ancillary effect of alleviating elasticity problems. The SP has argued that demand for its services over the involved lines is more elastic than that of the MP as evidenced by SP having a lower rate of return than the MP. Thus, if rates were raised to cover a high rental, the SP would lose business.

The SP's arguments have some merit. Use of a one year time period, in effect, would make rent an avoidable cost and would force more elastic traffic to make the same

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[20] Usage share calculated as the ratio of tenants' gross-ton-miles to total gross-ton-miles of all users was approved for trackage rights granted to MKT over MP's lines. *See 1984 decision,* at 803.

relative contributions as less elastic traffic. This would, as SP has asserted, make it difficult for the tenant carrier to compete for more elastic traffic and goes against the Staggers Act direction to allow prices to reflect demand. To alleviate this problem, we believe that usage factors should be based on three years of data. While this does not entirely eliminate the problem, it is the best methodology available to us and should reduce it to an acceptable level.

CONCLUSION

As noted in our consolidation decision, "terms so onerous to the tenant as to defeat the purpose of the trackage rights cannot be considered just and reasonable." *UP—Cont.—MP; WP, supra* at 590. We noted that valuation of property should be based on an allocated share of return on the fair market value of the property. *Id.* at 589. Our merger decision stated "a rate of return based on current cost of capital may not be reasonable." *Id.* at 589-590. Upon reconsideration we have determined that we must use current cost of capital in order to determine reasonable compensation for the trackage rights granted in our prior decision. We have approached this finding trying to balance two interests: needed competition in the central corridor promoted by just and reasonable compensation terms; and rational compensation to the owning road.

We believe our revisions to the formula reconcile these goals, and we find the compensation terms just and reasonable. We have tried to approximate the allocated value of these lines. Our refinements to the formula concerning use of 1979 data; bridge traffic; moving usage factor; market value of the MP; and roadway valuation are designed to place the renter in a similar position as the owner. By placing the renter in the same position as the owner, we believe we have achieved our goal of assuring a competitive relationship between the two systems on the line.

This decision will not significantly affect either the quality of the human environment or energy conservation.

VICE CHAIRMAN LAMBOLEY, dissenting in part:

I would continue the use of the actual rate of return on investment for the MP rather than the pre-tax cost of capital in the interest rental compensation formula. In order to allow the trackage rights tenant a reasonable opportunity to compete with the landlord, the terms of the trackage rights rental must reasonably conform to the economic conditions under which the landlord operates. The use of the pre-tax cost of capital in the compensation formula will unreasonably disadvantage the trackage rights tenant in its ability to compete and thus may defeat the purpose of the award of trackage rights.

It is ordered:

1. The DRGW's motion to reject the UP/MP filing and to strike the verified statement of Gregory H. Dickinson and Gregory M. Broderick are denied.

2. The DRGW's request to strike the UM/MP letter is granted.

3. In Finance Docket No. 30,000 (Sub-No. 16), the 1979 net earnings, based on bridge traffic, were $18,287,939, without and adjustment for IPD.

4. In determining interest rental in Finance Docket No. 30,000 (Sub-No. 16) and (Sub-No. 18), our capitalized earnings formula has been modified in include: (a) railroad, instead of corporate earnings and investment; (b) 1979 data, instead of adjusted 1982 data; (c) pre-tax cost of capital, instead of actual rate of return on investment; (d) use of roadway property only in developing the multiplier; and (e) usage based on a three-year moving average.

5. These proceedings are reopened to receive evidence on the market value of road property, the Pueblo-Kansas

City line earnings, and the proper incentive per diem expense for the Kansas City St. Louis line. Statements are due February 22, 1988, and replies are due March 23, 1988.

6. This decision is effective January 8, 1988.

By the Commission, Chairman Gradison, Vice Chairman Lamboley, Commissioners Sterrett, Andre, and Simmons. Vice Chairman Lamboley dissented in part with a separate expression.

APPENDIX A

I.C.C. EARNINGS MULTIPLE CALCULATION OF INITIAL INTEREST RENTAL FOR MP LINE BETWEEN PUEBLO, CO, AND KANSAS CITY, MO

I. Development of earnings multiple.

MPC Value

1982 MPC stock price	$ 998,910,000	
1982 MPC liabilities	+$1,361,814,000	
Total 1982 MPC value		$2,360,724,000
1983 MRTC stock price	$ 256,300,000	
1982 MRTC liabilities	185,443,000	
Total 1982 MRTC value		-$ 441,743,000
Total 1982 value		$1,918,981,000

MPC Earnings

1979 MPC operating earnings	$ 262,966,000	
1979 MPC non-operating income	+ 36,541,000	
Total 1979 income before interests and taxes		$ 299,507,000
Times GNP Deflator		x 1.26805
MPC earnings expressed in 1982 dollars		$ 379,790,000
1982 MRTC earnings		-29,100,000
Total earnings expressed in 1982 dollars		350,690,000

Earnings Multiple

Total 1982 value	$1,918,981,000
Total earnings expressed in 1982 dollars	+ 351,197,000
Earnings multiple	5.47

II. Rate of Return

ICC ROI using MP 1979 R-1	8.37%
1-0.18 (MP's 1979 effective tax rate)	÷ 00.82
	10.21%

III. Interest rental

	Pueblo to Osawatomie	Osawatomie to Kansas City
1979 earnings	$ 3,473,037	$ 2,404,409
Earnings multiple	x 5.47	x 5.47
Valuation of investment base	$ 18,997,512	$ 13,152,117
1979 pre-tax ROI	0.1021	0.1021
Total return	$ 1,939,646	$ 1,342,831
DRGW usage share	0.80	0.37
Interest rental (segment)	$ 1,551,716	$ 496,848
Total interest rental	$2,048,564	

APPENDIX B

Development of Pre-Tax Cost of Capital Rates

1982 to 1986

Proceeding		After Tax (1)	Pre Tax (2)	Cap Structure Mix (3)	Weighted Cost (4)
1982					
Ex Parte No. 436	Debt (Current)	14.00%	14.00%	37.00%	5.18%
August 4,	Equity	19.80%	36.67%	63.00%	23.10%
1983	Composite Cost				28.28%
1983	Debt (Current)	11.70%	11.70%	29.40%	3.44%
Ex Parte	Equity	16.80%	31.11%	70.60%	21.96%
No. 452					
October 31,					
1984	Composite Cost				25.40%
1984	Debt (Current)	12.80%	12.80%	33.90%	4.34%
Ex Parte	Equity	17.30%	32.04%	66.10%	21.18%
No. 458					
January 6,					
1986	Composite Cost				25.52%
1985	Debt (Current)	11.10%	11.10%	28.80%	3.20%
Ex Parte	Pref. Equity	10.60%	19.63%	2.30%	0.44%
No. 464					
March 16,	Common Equity	14.70%	27.22%	68.90%	18.76%
1987	Composite Cost				22.39%
1986	Debt (Current)	8.9%	8.9%	34.8%	3.10%
Ex Parte	Pref. Equity	8.7%	16.1%	1.6%	.26%
No. 466					
August 21,					
1987	Common Equity	13.4%	24.8%	63.6%	15.77%
	Composite Cost				19.13%

NOTES:
Pre-Tax cost of equity = after-tax cost of equity divided by one minus the statutory tax rate (46%).
Weighted cost of capital is developed by multiplying the capital structure mixes by the pre-tax costs for each component.

APPENDIX C

CONCLUSION: Based upon our evaluation and resolution of the cost and revenue issues raised by the two parties, and as shown in Appendix D, the combined base and post-merger net earnings value of the Kansas City-St. Louis line segment amounts to $18,287,939, without an adjustment for incentive per diem.

I. *INTRODUCTION*

Southern Pacific Transportation Company (SPT) and St. Louis Southwestern Railway Company (SSW), collectively referred to as "SP," have submitted their supplemental evidence with respect to the calculation of an interest rental component of compensation for a grant of trackage rights over the lines of the Missouri Pacific Railroad Company (MP) between Kansas City and St. Louis. This evidence was filed in response to the decision of the Commission served August 30, 1984, in the proceeding cited above.

The Commission's August 30, 1984, decision held that the proper method of determining the value of lines subject to a trackage rights condition is the capitalized earnings approach. Since neither SP nor Union Pacific Railroad Company/Missouri Pacific Railroad Company (collectively referred to as "UP") had provided evidence which would be necessary to determine net revenues for MP's Kansas City-St. Louis lines, the Commission directed that both parties develop such information.

The extent to which the parties vary in their determination of net revenues attributable to Missouri Pacific's (MP) operations on the Kansas City, Mo.-St. Louis, Mo. line segment is measured below:

Base Year (1979) Traffic Plus Diversion Traffic

	MP/UP	*SP/SSW*
Gross Revenues	$120,655,831	$113,331,837
Cost	$ 82,513,164	$107,471,273
Net Earnings	$ 38,142,667	$ 5,860,564

The marked disparity in the net earnings and interest rental figures submitted by the parties is the result of numerous adjustments applied by SP to the revenue and cost study data alleged by MP to reflect its base year 1979 as well as its post-consolidation operations on the line in question. SP's restatement of the evidence was designed to correct what it refers to as obvious overstatements of revenues and understatement of costs existing in the MP study.

II. *EVIDENCE OF THE PARTIES AND COMMENTS FROM THE SECTION OF RAIL COSTING (SRC)*

A. *Revenue Adjustments*

1. *Unmatched Revenues*

The MP traffic study for base year 1979 contained revenue records that could not be computer-matched with operating records. There was carload traffic data indicating origin and destination points but not the route used intermediately. Since some of that traffic indisputedly used the trackage rights segment between Kansas City and St. Louis, MP applied a 12% factor against the identified revenue amount between the two points to provide Kansas City-St. Louis traffic contained in the unmatched revenues. This 12% adjustment increased net revenues by $3,263,617. MP believes it has made a fair resolution of a computer-related problem that failed to identify precisely all the revenues attributable to the Kansas City-St. Louis line.

The SP restatement deletes this element. SP is skeptical in general about the MP revenue study, declaring that

little reliance should be placed upon a calculation of revenues that requires a 12% adjustment factor to correct the infirmities discovered in its examination of sample waybills. The 12% factor is not substantiated in supporting workpapers.

COMMENTS

We agree with MP on the concept that a portion of unmatched system revenues should be assigned to the corridor traffic. In addition, the procedure used by MP to correct the unmatched revenue issue appears reasonable in our judgment. Only 12% of the total system unmatched revenue figure has been assigned to routings involving the trackage right segment. It appears to be a reasonable estimate. While we acknowledge that SP has detected some inconsistencies in the MP revenue study we do not believe that this invalidates the study. Our restatement will retain the 12% adjustment factor.

2. *Local Traffic Revenues*

The MP revenue study contained local traffic generated along the Kansas City-St. Louis line. Its position is that the capitalized earnings approach adopted by the Commission uses an earnings multiple methodology based on all line-specific net revenues. Therefore, the earnings potential must reflect the net revenue potential of all traffic moving over each trackage line.

SP argues that the limited trackage rights it received from the UP/MP merger denies it the freedom of opportunity to compete for the local traffic. It is not receiving the full value of the line in terms of service potential. Moreover, while the limitation upon the traffic it can operate on the Kansas City-St. Louis bridge has the effect of assigning a lower usage share to the tenant railroad, SP believes it would be better served by sharing such traffic. Failing that, it concludes a fair method would be

to exclude local traffic revenues which have the effect of enlarging SP's interest rental payments.

SP was authorized only bridge rights on the Kansas City-St. Louis line. Although SP has the right to interchange cars with other rail carriers at five specified points along the trackage, it cannot originate or terminate traffic at intermediate points. Accordingly, SP maintains that any MP traffic which originates or terminates at any intermediate point on the Kansas City to St. Louis line or any traffic which MP interchanges at points other than those approved by the Commission for SP, should have its revenues excluded from the valuation study. An exclusion of such traffic and revenue from the valuation study would be consistent with the scope of the trackage right authority granted SP in the Commission's decision.

SP's restatement of UP's earnings study eliminates the local traffic identified as being generated by MP on the line in 1979. The extraction from the revenues is accompanied by a reduction in local traffic expenses based upon a revised calculation of physical units and the MP/UP unit cost data. The exclusion of traffic related to local operations on the line results in a $4,060,377 revenue reduction.

Comments

While SP is not questioning the Commission's rationale for granting the carrier restricted trackage rights, it has established a legitimate point. We do not believe that the SP should pay interest rental on rights it cannot exercise, namely the ability to originate, terminate or in some cases, interchange traffic at intermediate points on the line. On balance, we find that SP's exclusion of local revenues from the valuation base is reasonable taking into account as it does the collateral expenses MP incurred, and we will adopt the adjustment in our restatement.

B. COST ADJUSTMENTS

1. *Through and Way Train Mileage*

The MP study assumed that all carload traffic routed over the Kansas City-St. Louis segment moved in through trains. MP concedes that while its 1979 MPRR Form OSA indicates that about 13.4% of total car-miles over the system moved in way trains, those system average figurs are not representative of the traffic moving over the Kansas City-St. Louis line that year. According to MP, most of the traffic over that line moved in through trains.

SP argues that while it may be true that actual train movements for handling traffic over this one segment of line may indeed take place in through trains, it is erroneous to assume that no way train handling exists at distribution or gathering areas beyond Kansas City or St. Louis where such traffic originated or terminated on MP lines. Any costs incurred in these operations should be reflected in the study.

SP applied an adjustment to modify the MP through train costs by inserting an element of way train movement. In the restatement of MP's costs, SP used an average way train handling per carload (excluding unit train and TOFC carloads) of 52 loaded miles per car plus the equivalent empty miles. The basic methodology for the modification is supported by an exhibit.

COMMENTS

We find nothing unorthodox in SP's attempt to introduce way train mileage into the expense picture. Average train data represents the system average mixture of way trains and through trains. Average train costs when applied take into account carload movement where both types of line-haul are employed for the service.

Based upon its prior studies, the Commission has always considered it worthy, where appropriate, to separate line-

haul expenses between through and way train operations. MP has not provided sufficient detail upon the traffic to warrant exclusive application of through train unit costs. We will include the adjustment in our own restatement.

2. ***Unit Cost Adjustment—Unit Train v. Through Train***

In the MP cost study, a separate unit train gross ton-mile cost was applied to unit trains and a combined unit train/through train cost applied to through train movements.

SP maintains that the through train movements were the beneficiaries, as reflected in MP's unit cost, of any efficiencies associated with unit train operations.

The purpose of this adjustment by SP is to provide a "make whole" adjustment where MP has developed separate unit train costs for application to unit train movements along the line segment. The basis for that adjustment is that where a separate unit train cost is developed, the through train cost must be adjusted to exclude the specific unit train costs.

This SP adjustment employs a technique that was not utilized by MP in developing separate costs for unit trains and through trains. No contradictory viewpoints were expressed in rebuttal.

COMMENTS

We agree with SP that MP should have excluded the unit train data from unit expense calculations designed to obtain cost of through train operations. Since the adjustment has the effect of increasing MP's through train unit cost, MP's understated through train costs are thereby corrected in its favor of SP. The increase will be incorporated into our restatement.

3. ***Unit Train Terminal Switching***

During 1979 MP operated unit trains with 50 or more carloads of coal per train over the trackage rights line.

In costing this traffic, MP modified regular carload costs for terminal switching by applying only 10% of the Rail Form A expense for this function. This was done to reflect the reduced effort in switching unit trains at terminal points. The Commission's Burden Study was referenced by MP as the basis for the adjustment that excludes 90% of regular expense.

In order to correct what it believes to be an understatement of the terminal switching expense for unit train carloads, SP has revised the MP study to eliminate only 75% of the average switching expense in lieu of 90%.

COMMENTS

The MP adjustment that reduced terminal switching expense by 90% in the movement of unit trains is not supported on the existing record. MP's discussion related to its study is not enlightening about the source of that reduction factor.

Neither the Burden Study, Publication 1S3-72, *Rail Revenue Contribution by Commodity and Territory*, to which MP refers nor the Commission's decision in *Investigation of Railroad Freight Rate Structure, Coal*, 345 I.C.C. 71 (1974) authorize a reduction in terminal switching expense of the magnitude of 90% for multiple car shipments. SP's correction to limit the reduction in switching expense at terminals to 75% of Rail Form A average switching expense is more attuned to the figure recommended by the Commission in both the Burden Study and in *Investigation of Railroad Freight Rate Structure, Coal, supra*. We will accept SP's corrected expense figure in our restatement.

4. *Unit Train Empty Car Miles*

In costing the unit train movements on the Kansas City-St. Louis line segment during 1979, MP did not apply a 100% empty return ratio. Instead, MP assumed system empty return ratios based on average total miles divided by loaded miles, for the types of equipment employed in

unit train operations. Car types used on the trains were hopper cars and equipped gondolas. MP costed on the basis of a ratio of 1.83 for average total miles to loaded miles for hopper cars and 2.09 for equipped gondolas.

SP found that MP had understated its unit train car-mile costs both for railroad owned equipment and private cars by failure to apply a 2.0 ratio as a standard operating characteristic for this type of traffic. In defending its restatement of the empty car miles associated with the return haul of MP's unit trains, SP points out that the assumption of 100% empty return is a conventional approach where the reverse is the same distance as the forward route of movement.

COMMENTS

MP's decision to apply system average empty return ratios to the equipment involved in dedicated unit train operations is inappropriate. Unless there are circumstances prevailing in the train turnaround pattern that are dissimilar to the prior inbound movement, then the SP assumption of a 100% empty return movement over the identical route is warranted. MP has not supported the use of an empty return ratio other than 2.0. We accept SP's restatement and support its argument that a less than 100% empty return ratio is inconsistent with assumed unit train operating efficiencies.

5. *Unit Train Interchange Switching*

The MP cost study has made no provision for interchange costs for unit train movements. The subject is not treated in detail in MP's evidence.

SP objects to the total omission of this cost element for unit trains, citing the lack of support offered by MP. Using two Commission studies on multiple car movements as a reference, SP concludes that the interchange costs for MP's unit train movements should be based upon 50% of the interchange cost for single carloads. In its restatement of

MP's study, SP followed the 50% criteria alleged to govern this situation and added interchange costs as an expense element in lieu of the arbitrary elimination of interchange costs adopted by MP.

COMMENTS

While MP has offered no explanatory support for the total omission of this cost element, its approach to the matter is doubtless governed by an awareness of the special arrangements under which its unit trains are operated. Usually under these arrangements the standard interchange procedures are dispensed with for the sake of speed and handling efficiency. Where so called "run through" trains are involved, there is generally no change of railroad power equipment associated with carrier interchange from origin to destination. In these circumstances the current state of the art rules out the inclusion of certain costs advocated in earlier multiple car movement studies. The SP adjustment to add this as an expense element is not acceptable.

6. *Unit Train Station Clerical*

MP calculated station clerical costs for unit trains by using a split on a per-train and per-car basis, allegedly derived from the Commission's Burden Study. MP applied 46% to the train portion of unit train station clerical costs and 54% against the car portion of unit train station clerical costs.

SP finds no supporting studies for these specific percentage allocations in MP's underlying workpapers and points out that the percentages are not found in the Commission decisions that accepted multiple car adjustments. Based on the applicable adjustments adopted in *Investigation of Railroad Freight Rate Structure, Coal, supra,* proceeding and from the Burden Study, SP revised the MP figures by appying a 75/25% split. Accordingly, 75% of per car station clerical cost was allocated on a per-car

basis and 25% of that cost was allocated on a per-shipment basis.

COMMENTS

MP's employment of a 46/54% division on this expense element rests on an assumption for which we lack any details. As we have no familiarity with the figures chosen by MP we must regard them as arbitrary. In the absence of support, we will adopt the 75/25% allocation advocated by SP in our restatement.

7. *Terminal Switching Costs—St. Louis*

For the base year 1979 traffic MP computed intermediate and terminal switching expense for the issue traffic at the St. Louis terminal area based upon the system average interchange cost of $12.32 per interchange, loaded or empty.

SP contends that the system average figure understated the real nature of this cost element at St. Louis. It points out that in October 1979, the actual charges of the Terminal Railroad Association of St. Louis (TRRA) were $83.49 per carload for intermediate handling (interchange) and $191.33 per carload for industrial switching. The Alton and Southern Railway Company (A&S) charges for the same services in October 1979, were $68.90 and $141.93, respectively. Because of the vast difference between $12.32 and the actual charges assessed for St. Louis switching, SP attempted to estimate the traffic and the actual cost of switching at St. Louis, and to substitute those costs for average Rail Form A values in its restatement.

MP was convinced that such an exercise was not appropriate for the base traffic, which involved far more movements with considerably less information about movement parameters, than the post-merger diversion traffic. (Both parties are in agreement over post-merger diversion traffic interchange costs at St. Louis.) According to MP, to attempt to adjust the switching cost at only a single

junction in the St. Louis area is apt to produce switching costs that are distorted in total.

Notwithstanding the scope of the problem, SP developed information pertaining to MP payments to TRRA and A&S during 1979. In a separate study, SP made an attempt to construct additional terminal switching costs which were properly allowable to traffic using the Kansas City-St. Louis lines and which were incurred at St. Louis in connection with the handling of the base traffic. The study indicated that a conservative figure of 50% could be used as representing those cars which would involve terminal company handling (and additional expense) at St. Louis. SP then adjusted the terminal company handling expense for these carloads by extracting from it the Rail Form A system average terminal switching cost and applied the adjusted figure against the applicable service units.

COMMENTS

SP is advocating a switching cost adjustment which is technically legitimate in these circumstances if it can be practicably applied. Because of the exceptional nature of switch operation charges in the St. Louis terminal area, it is misleading to attempt to impute the system average switching cost to be representative of MP's expense for the issue traffic. MP's treatment of the matter is superficial at best, and as a result, the allegation by SP that the St. Louis terminal switching costs are seriously understated can be sustained. While MP stated various reasons for not making an adjustment study, its insistence that the application of Rail Form A averages for the base traffic is appropriate cannot be supported.

In our view, it is preferable that the net revenue earnings approach reflect some element of actual St. Louis interchange switching expense than the totally unadjusted costs submitted by MP. While it is true that the SP study employs an arbitrary traffic assumption, we have reviewed the adjustment procedure and it appears to be conceptually

sound. However, we will incorporate into our restatement corrective action for the following inaccuracies that MP has discovered in the SP adjustment:

(1) Eliminate the $5.97 bridge charge per loaded car for Mississippi River crossings. This expense is already included in the joint facility costs from Rail Form A.

(2) Alter the TRAA and A&S interchange switching charges to reflect average 1979 charges over the entire year rather than the October 1979 level. The charges were also incorrectly increased for general overhead.

(3) Eliminate the overstatement in the interchange switching costs for the post-merger diversion traffic by approximately one half because they were not reduced by the appropriate mileage pro-rate factor of 49.45%.

8. ***Car Inspection—Railroad-Owned Cars***

Because MP's study used per diem rates in lieu of the RFA car ownership costs, and made no provision for separate development and inclusion of car inspection costs for railroad-owned cars at the private car rental level, SP found it necessary to adjust the study values so that this expense element is not overlooked. Car inspection expense (user's repairs) for railroad-owned cars is not included in the per diem rates because these costs have been removed in the development of Rail Form H.

SP corrected the omission by multiplying the car inspection unit cost for private cars by the variability ratio of 86% and applying the resulting unit cost against the mileage traveled by railroad-owned cars. The addition of these car inspection costs for railroad-owned cars not provided for in the MP study was required for both base traffic and post-merger traffic.

COMMENTS

MP has made no rebuttal to this evidence. There is a distinction between the value of per diem rates and RFA

car ownership in connection with car inspection costs for railroad-owned cars has apparently escaped the attention of MP. The expenses identified and developed by SP are properly includable in the total costs of traffic moving over the Kansas City-St. Louis lines.

9. *Intertrain and Intratrain Switching—Diversion Traffic*

MP's method for estimating the number of I&I switches for the involved traffic in the base year was to assume no switches taking place in the Kansas City-St. Louis corridor. For the continuation of the movements on MP, switches would occur once every 200 miles. Thus, by deducting corridor mileage from total miles and dividing by 200, the estimated number of I&I switches could be obtained and then multiplied by the applicable unit cost.

For the captured traffic following the merger MP used an alternate approach, and SP has taken exception to it. Under the MP approach, the traffic added from diversion will require virtually no added switching expense. Any I&I switching expense added would attach to the additional traffic in those instances where extra switching assignments were anticipated following the UP/MP consolidation. This incremental cost approach, which assumes that all new traffic can be generally handled with existing resources, and which SP opposes, assumes for example that UP/MP could handle 154,604 additional cars at an incremental cost of $6,710.

COMMENTS

In projecting the impact of post-merger traffic MP has taken the incremental cost approach in regard to intertrain and intratrain switching. This approach is the source of costing issues that exist between the parties here as well as in other situations where switching is performed. MP has made the judgment that any of the additional traffic that requires I&I switching can be handled with the ex-

isting crew capabilities. The increase in I&I activities can be performed with little or no increase in variable expenses. Added costs arise whenever a traffic overflow mandates additional switch engine requirements.

We will accept the approach advocated by MP in this matter and reject SP's adjustment which would increase considerably MP's variable costs for I&I switching on the post-merger traffic. To reject MP's incremental cost approach in favor of SP's convictions would be to place the Commission in the position of substituting its views on operating circumstances over those of the MP operating personnel better qualified to render judgment on this matter.

10. *Interchange Switching—Diversion Traffic*

In analyzing the characteristics of the traffic gained by diversion after merger with UP, MP here again chose to apply an incremental approach in the case of interchange switching costs. In MP's estimation, the anticipated new traffic would be such as to preclude any requirements for carload switches to other carriers along the route of movement. MP eliminated this element entirely as an operating expense.

SP has rejected MP's incremental approach and has performed an adjustment to the post-merger study by adding expenses of $3,787,482 for interchange switching (307,354 pro-rated switches at $12.32 per switch).

COMMENTS

For the same basic reasoning that guided us in the previous consideration of the I&I issue raised by SP, we are rejecting the SP adjustment to the diversion traffic. In doing so we recognize that MP's incremental approach is based upon its understanding of the parameters of that traffic and we will abide by those assumptions. That data is not in the scope of this proceeding. The stand taken by SP fails to accept the logic that the new traffic will be attracted to the merged line because the consolidated sys-

tem now has the capacity to forward long distance traffic without the need to interline with other carriers.

11. *Carload Terminal Switching—Diversion Traffic*

MP projected that the traffic gained from diversion could also be accommodated for the most part with existing terminal switching capacity. Increased expenses were only anticipated to occur in a minimum number of instances where switching crews had to be augmented for new assignments.

SP objects to the incremental cost approach adopted by MP in this area as well. To correct what it believes is a sizeable understatement by MP in terminal switching expense, SP determined from Rail Form A averages a more suitable number of terminal switches for the involved traffic.

COMMENTS

Based upon the position taken in the previous issues related to incremental costing, we defer to MP's judgment in this matter and we will reject the SP adjustment in our restatement.

12. *Interchange of TOFC Traffic*

In determining costs of service related to trailer-on-flat car (TOFC) movements using the Kansas City-St. Louis trackage lines, MP made no provision for certain interchange activity at St. Louis. Specifically, this type of interchange arises when the flat cars bearing trailers are not physically transferred to connecting carriers. The interchange service involves a physical transfer of trailers over the highway from the ramping area of one carrier to that of another for reloading and forwarding.

SP points out that at most Mississippi River crossing points at St. Louis, the physical handling of the interchange requires ramp spotting, unloading, highway movement and reloading of each TOFC vehicle. The entire

function replaces what in other areas would amount to a standard flat car interchange including trailers. In those instances where such an interchange takes place the inclusion of the Rail Form A interchange cost will not adequately reflect the full cost of the activities involved in transferring the trailers at the river interchange point. Therefore, from TOFC data provided by MP, SP has attempted to insert some level of expense which MP would incur in these operations which was otherwise omitted from the study.

COMMENTS

We agree with SP that the so called "rubber" interchange of trailers at Mississippi River crossing points is an actual element of expense encountered in TOFC operations. To the extent they are not included in an overall cost study, there is an understatement of cost to MP over the Kansas City-St. Louis line segment. An adjustment is warranted in our opinion. We will accept the minimal provision SP has made to include this expense because it appears to be conservative ($28,000 for the base traffic and $85,463 for the TDS traffic), and despite the absence of support by SP in arriving at those figures. The undefined nature of the adjustment may be attributable to the limited information provided SP by MP for this purpose. In any case, we believe that in implementing the net earnings approach that determines the interest rental amount payable by the tenant railroad, it is preferable to include some element of highway interchange expense than to ignore it.

13. ***Auto Rack Equipment—Overhead Ratio***

MP's base tgraffic and TDS projections contain rental costs for auto rack equipment in multi-level automobile transportation service. It employed an appurtenance rate table for a rack valued at $32,000, using a five year life cycle with a daily rate of $18.00.

While SP concurs with this development of auto rack rental costs, it has adjusted the MP daily rate to include an element of general overhead attached to the use of this equipment. The daily rate was increased by the factor of 8.54% to reflect the actual cost of auto rack rental to MP. SP restated MP's total rental expenses accordingly.

COMMENTS

Since MP neglected to consider the factor of general overhead expense applicable to auto rack rental, we accept SP's adjustment as proper for a restatement.

14. *Incentive Per Diem*

In the MP study the car hire rates shown for railroad-owned cars represent the average 1979 per diem rate level for foreign-owned cars. They do not, however, reflect any of the incentive per diem payments which MP presumably incurred for the use of cars owned by foreign railroads. To correct this exclusion, SP employed the average MP per diem figures but increased them to provide for incentive per diem payments during 1979 based on a study of average age and value for the various ICC car types.

In rebutting this adjustment, MP points out that it is improper to apply these incentive rates on foreign cars without also taking into account the incentive per diem received by MP for system-owned cars on foreign lines. The general Rail Form A procedure is to compare payments with receipts and to apply the net amount in the event it is a net payable. For this proceeding, MP's costing procedure avoided the subject of incentive per diem because the share of the net payable figure allocable to the study traffic was too minimal for inclusion, not to mention the complexity of treating both payables and receivables in the costing methodology.

COMMENTS

By ignoring incentive per diem credits to MP in its equation, SP has performed an adjustment that grossly

overstated this cost additive. It is noted that for the year 1979 MP had incentive per diem receivables of $7,165,000 and incentive per diem payables of $7,951,000. The net payable deficit, $786,000 is less than one tenth of the amount SP applied in restating incentive per diem charges. We will not accept any portion of SP's restatement of this expense element. The net amount payable, after consideration of receivables, represents a system figure. However, since $786,000 is a system deficit amount, a portion of it should be attributed to corridor operations. As noted in our decision here, *supra,* we are unable to correct SP's adjustment to reflect the appropriate IPD expense from the supporting evidence on the record. Therefore, MP's line specific net earnings, as restated, reflect no allowance for IPD expenses. Parties may submit further evidence on this issue.

15. *Update—Per Diem Car Repairs*

This issue stems from SP's adjustment of car costs (car hire) on MP system cars to include separate additives intended to reflect the cost of car repairs at a 1979 cost level. In the absence of actual MP freight car repairs by car type, SP developed the additives by calculating the difference between the average 1979 car repairs reported in the annual reports of Class I railroads and the car repair in the per diem rate ($1,519 minus $956 equals $563). The difference was split by half to time and mileage and additive rates per mile and per day were then determined.

MP claims that a better approach is to index the 1974, 1975 and 1976 car repair components of per diem in Ex Parte No. 334 to a 1979 level by applying an appropriate updating ratio from Association of American Railroads indices. In that way the Ex Parte No. 334 methodology is sustained while at the same time producing accurate 1979 car repair levels. The difference between the newly indexed rates and the actual per diem/mileage rates formed the basis for computing additives. An annual car repair

amount of $1,345 was determined from this procedure by MP.

COMMENTS

MP's basic study contains no provision for updating of per diem car repair expense. This element should be considered in this proceeding as a part of the effort to determine the earning power of the Kansas City-St. Louis line segment. While MP did not implement its recommended procedure for the purpose of including these expense additives, we think it is preferable to the approach employed by SP. We agree with MP that its figure of $1,345 is more consistent with the Ex Parte No. 334 guideline and gives a more accurate version of 1979 costs. We will include updated per diem car repair costs in our restatement based upon the results indicated in the MP procedure.

16. *Constant Costs*

The MP study developed constant costs for the 1979 base year traffic using the ton and ton/mile methodology from Rail Form A. For the post consolidation traffic, that resulting from diversions gained through its merger with UP, MP made no distribution of fixed costs to show a fully allocated level. First, MP believes that the expenses for the traffic diversion gains represent variable costs only, and that the aggregate fixed cost base was sufficient to cover the additional traffic following merger. Secondly, the MP approach avoids any need for preparing a pro forma post-consolidation Rail Form A spreading projected post-consolidation constant costs across projected post-consolidation traffic. While this would yield a lower constant cost per unit of traffic, MP contends that such an exercise would be too difficult and time-consuming to be practical and would not produce an appreciably different result.

SP has raised two issues regarding MP's procedures. The first issue concerns failure to allocate fixed costs to the post consolidation traffic diversions. Second, SP rejects

the ton and ton-mile method used by MP as being inappropriate; the percentage mark-up method is alleged to be preferable in this proceeding because it reflects the same components of costing that Rail Form A utilizes.

SP adjusted the MP study by developing a mark-up ratio which was applied to the variable cost base for both the base year and post-consolidation periods. To achieve what it believes is an appropriate mark-up ratio in producing a fully allocated cost figure, SP modified the constant cost portion of unit costs to reflect post-consolidation operations. Specifically, the procedure reallocates pre-consolidation constant costs over post-consolidation service units. In 1979, MP's total variable and total fixed and common costs were shown as follows:

MP Total Variable Cost	$1,011,780,255
MP Total Constant Cost	$ 237,679,396

To the 1979 variable cost base was added the estimated costs reflecting the impact of the merger, in terms of diversion traffic, on MP's variable costs. Estimates of these increased variable costs were placed at $53,996,298. The base was thus increased to $1,065,776,553. The relationship of MP's 1979 constant costs to the variable costs for the post-consolidation traffic base (1979 base traffic plus diversion traffic) results in a percentage of 22.30 which was used to increase variable costs to the fully allocated level in replacement of MP's ton and ton-mile methodology.

COMMENTS

Notwithstanding MP's convictions about the avoidable cost nature of diverted traffic, and its acknowledged difficulties in assigning constant costs to the post-consolidation traffic, we believe that its reluctance to adhere to the Commission's directions has contributed heavily to this issue. By its failure to spread constant costs in some manner over the entire post-consolidation traffic situation MP has contributed a less than accurate expense showing in

the type of proceeding in which net earnings are essential in making a determination of interest rental. The net earnings concept requires a fully allocated cost level. SP has made an attempt to correct MP's omission of data for the post-consolidation operations. Moreover, because MP also failed to provide statistical data on the tons and ton-miles related to diverted traffic acquisitions moving over the Kansas City-St. Louis segment, SP was forced to structure its restatement by using a ratio mark-up of variable costs in lieu of the ton and ton-mile method. We will adopt SP's restatement of constant costs as the better evidence of record on that element.

III. SUMMARY

Our preceding discussion indicates that certain flaws and omissions exist in the MP cost evidence which SP has attempted to correct in its restatement. As a general statement it can be said that MP's measurement of net earnings for the 1979 base traffic and its post-merger earnings on the Kansas City-St. Louis line segment were overstated by reason of incomplete cost data, and that its estimate of an annual interest rental payable by the tenant SP is excessive.

Because of a need for revision of the data submitted by the parties, we have fashioned a restatement of the cost and revenue study values, incorporating the adjustments discussed above. Our restatement (Appendix D attached) adjusts MP's net earnings of $38,142,667 to $18,287,939.

APPENDIX D

ICC RESTATEMENT OF MISSOURI PACIFIC RAILROAD'S REVENUES AND EXPENSES FOR THE COMBINED BASE YEAR AND POST-MERGER TRAFFIC OVER THE KANSAS CITY-ST. LOUIS LINE SEGMENT

Missouri Pacific's Base Revenues	$ 81,518,334
Missouri Pacific's TDS Revenues	35,861,111
Unmatched System Revenues Allocated to Line	3,263,617
Southern Pacific Revenue Adjustment	245,527
	$120,888,589
Less: Revenues From Local Traffic	4,060,377
Total Adjusted Revenues	$116,828,212
Missouri Pacific's Base Costs	$ 54,518,334
Missouri Pacific's TDS Costs	27,994,830
	$ 82,513,164
Plus: Acceptable Southern Pacific Adjustments	16,027,109
Total Adjusted Costs	$ 98,540,273

Adjusted Revenues	$116,828,212
Adjusted Costs	98,540,273
Combined Earnings	$ 18,287,939

ST. LOUIS SOUTHWESTERN RY. CO. COMPENSATION-TRACKAGE RIGHTS

FINANCE DOCKET NO. 30,000 (SUB-NO. 16)

ST. LOUIS SOUTHWESTERN RAILWAY COMPANY-TRACKAGE RIGHTS OVER MISSOURI PACIFIC RAILROAD COMPANY-KANSAS CITY TO ST. LOUIS

Decided May 17, 1989

Petitions to reopen denied. A roadway multiplier of 0.439 and an incentive per diem of $29,753 shall be used in determining interest rental under the capitalized earnings formula employed in *Compensation II* for the Kansas City-St. Louis line segment.

BY THE COMMISSION:

On February 22, 1988, the Southern Pacific Transportation Company (SP) filed a petition requesting that the Commission reopen *St. Louis Southwestern Ry. Co. Compensation-Trackage Rights,* 4 I.C.C.2d 668 (1987), *(Compensation II).* We decline to do so. In *Compensation II, supra,* we also asked the parties to submit additional evidence on the market value of road property and the proper incentive per diem expense for the Kansas City-St. Louis line so that we could complete our analysis of the compensation issue. We here conclude that a roadway multiplier of 0.439 and an incentive per diem expense of $29,753 should be used.

BACKGROUND

The Commission approved the consolidation of Union Pacific Railroad Company (UPRR), Missouri Pacific Cor-

poration (MPC), Missouri Pacific Railroad Company (MP), and the Western Pacific Railroad Company (WP), under the common control of Union Pacific Corporation and Pacific Rail System, Inc. (collectively, UP), in *Union Pacific Control-Missouri Pacific: Western Pacific*, 336 I.C.C 459 (1982) (referred to as the consolidation decision). Several railroads, including Southern Pacific Transportation Company (SP) and its subsidiary St. Louis Southwestern Railway Company (SSW), Denver and Rio Grande Western Railroad Company (DRGW), and the Missouri-Kansas-Texas Railroad Company (MKT), opposed the transaction and filed responsive applications for the imposition of trackage rights conditions.

In approving the consolidation, the Commission identified several anticompetitive effects of the transaction that could be remedied by grants of trackage rights to competing carriers. The greatest competitive impact was noted in the central transcontinental corridor. To preserve competition in that corridor east of Denver, we conditioned approval of the merger on grants of trackage rights. One grant of such rights was to the DRGW between Pueblo, CO, and Kansas City, MO. We also granted the SP trackage rights between Kansas City and St. Louis. Finally, the Commission granted the MKT trackage rights over MP's lines between Kansas City and Omaha, NE, and between Union and Lincoln, NE, and over UP's lines between Omaha and Council Bluffs, IA, and between Kansas City and Topeka, KS, with use of related terminal facilities. We did not set the terms of compensation for the trackage rights because we prefer that the parties set the terms themselves. 366 I.C.C. at 589.[1]

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[1] On May 22, 1984, the Court of Appeals for the District of Columbia affirmed the consolidation decision in all respects material to these proceedings, but remanded for further consideration of an unrelated issue. *Southern Pacific Transportation Co. v. I.C.C.*, 736 F.2d 708 (D.C. Cir. 1984).

The MKT entered into trackage rights agreements with the UP and MP, and we approved them. *St. Louis Southwestern Ry Co. Compensation-Trackage Rights*, 1 I.C.C. 2d 776, 802-04 (1984) (*Compensation I*). The SP, DRGW, and the UP could not agree to terms for the Kansas City-St. Louis trackage rights. At the parties' request, we commenced proceedings to set the terms of compensation. *Id.* at 779.

In *Compensation I*, we found that the compensation should be determined in three parts: (1) the variable cost of operation including standard additives; (2) a proportionate share of maintenance and operation expenses based on the tenant's usage of the facility; and (3) interest rental. *Id.* at 779-80.

There was no dispute among the parties concerning variable costs and maintenance and operation expenses. *Id.* at 790-91 and 799. The parties disagreed about the interest rental factor. We found that interest rental should be based on the tenant's usage and the MP 1979 pre-tax rate of return on the value of the lines. In determining value, we adopted a capitalized earnings approach. *Id.* at 780.

Under this method, the earnings of the line segments were "capitalized" using an earnings multiplier derived by dividing the consideration the UP paid to acquire MP by MP's earnings (purchase price/MP earnings). Actual earnings of the particular line segment were then multiplied by the earnings multiple to arrive at an approximate value for the line segment. This figure was multiplied by the MP pre-tax return on investment. This amount was then multiplied by the percentage of usage of the tenant railroad (SP) to determine the total interest rental payment. *Id.* at 786-90. No net revenue figures were available for the Kansas City-St. Louis line; we directed the parties to submit calculations based upon the methodology we adopted to enable us to compute the interest rental component fairly and accurately. *Id.* at 801-02.

The SP and UP/MP filed petitions to reopen our *Compensation I* decision. The DRGW replied. We affirmed our earlier finding that the capitalized earnings approach is the proper method of determining the interest rental component. (*Compensation II, supra*). However, we found that each part of the formula should be modified, including: (1) use of railroad earnings and market value investment instead of total MP corporation earnings; (2) use of 1979 data, not adjusted to 1982 levels; (3) use of a multiplier based on the market value of roadway property only (not equipment); and (4) use of pre-tax current cost of capital instead of the railroad's actual rate of return on investment. *Id.*

We reopened the proceeding on our own motion to receive evidence on the market value of road property and the proper incentives per diem expense for the Kansas City-St. Louis line, *Id.* at 689. Petitions to reopen the proceeding were filed by the DRGW, SP, and UP (entitled a "pro forma petition to reopen")[2]. Subsequently, the DRGW and UP/MP reached a settlement agreement, approved by the Commission in *Denver and Rio Grande Western Railroad Company-Trackage Rights-Missouri Pacific Railroad Company-Between Pueblo, CO and Kansas City, MO.* (not printed), served October 25, 1988. Thus, the SP/UP compensation proceeding is the only continuing dispute before us.

On September 1, 1987, just prior to our decision in *Compensation II*, the Railroad Accounting Principles Board (RAPB or Board) released its Final Report. That report established eight Accounting Principles to govern the determination of costs for specific regulatory purposes. Competitive access was among the regulatory cost applications

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[2] The UP opposes reopening of this case. It argues, however, that if we do reopen the case, we should reconsider all issues not just ones listed by the DRGW or SP. Since we are not reopening this proceeding, the UP pro forma petition to reopen is denied as moot.

addressed by RAPB. We have now thoroughly considered RAPB's conclusions and recommendations and have incorporated them in this decision.

The remainder of this decision is organized into three distinct sections. The first provides a brief overview of our prior decision in *Compensation II* in light of RAPB's Final Report. The second provides a discussion of the evidence we requested and received pertaining to market value of road property and the proper value of incentive per diem expense for the Kansas City-St. Louis line. The third and final section addresses SP's petition to reopen.

DISCUSSION AND CONCLUSIONS

A. Review of Compensation II Decision. Our decision in *Compensation II* affirmed our finding in *Compensation I* and complies with the RAPB costing principles as they apply to competitive access. In reviewing the application of RAPB Principles to competitive access cases, we note the Board found that its Causality Principle entails the use of incremental costs in establishing a floor for compensation levels in such cases.[3] RAPB further defined those incremental costs under an avoidable cost concept as those "costs that would not have been incurred without the movement of the tenant's trains over joint tracks."[4] With respect to the issue of trackage rights, three factors need be considered in establishing appropriate compensation levels, namely: (1) the variable costs incurred by the landlord as a result of the tenant railroad's operations; (2) the tenant's share of maintenance and operation (M&O) expenses on a car-mile usage basis; and (3) the tenant's share of an interest rental component representing return on road property investment.

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[3] RAPB's Final Report dated September 1, 1987, Vol. 2, at 72.

[4] *Id.* at 72.

Both SP and UP were in agreement with respect to the first two factors to be given consideration in establishing equitable compensation levels. Because we prefer that the parties set the terms of such compensation themselves, we did not intrude into the determination of variable cost and M&O expenses associated with the grant of trackage rights. Our decision merely approved that portion of the compensation formula proposed by the parties. The use of variable costs *incurred as a result of tenant's operations* is clearly an application of the RAPB Principle of Causality and represents the level of costs that could be avoided by the landlord railroad if the tenant's traffic did not move over the joint track. Similarly, an appropriate *share* of M&O expenses, as recommended by RAPB, constitutes an approximation of those costs that are incrementally associated with the movement of tenant's traffic.

The parties have agreed on the measurement and use of these cost factors. Since we see no evidence to indicate that the development of these expenses includes anything other than those that would be avoidable, or appropriately shared, we find their inclusion here in conformance with the Principles established by the RAPB. In future proceedings, parties are free to introduce site-specific, or actual, expenses based on direct observation or special studies. However, when developing such evidence, parties should be guided by the RAPB Principles of Practicality and Homogeneity.

The third element of the formula we approved in *Compensation II* concerns the interest rental component (or return on investment).[5] In that decision, we affirmed the capitalized earnings approach as the proper method for determining interest rental compensation. However, we found that certain elements of the formula (previously ap-

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[5] RAPB indicated that "competitive access compensation levels may be set by the ICC so that, in addition to * * * incremental costs, common fixed costs are shared among the beneficiaries." *Id.* at 72.

proved in *Compensation I*) required revision. Specifically, we found that it is appropriate to use landlord railroad's earnings and market value investment instead of total parent company (MP Corporation) earnings in the earnings multiplier formula. This brings the formula in line with the RAPB Entity Principle. Further, limiting the earnings multiplier to roadway property only (currently under consideration on this reopened record) was likewise consistent with RAPB's Entity Principle. In this case, entity costs should be defined as those facilities "provided by one railroad for access by another."[6] Finally, our use of current market value and a pre-tax current cost of capital meets the requirements of RAPB's Principles relating to Asset Valuation and Cost of Capital.

A return on current market value, at a current nominal cost of capital rate, reflects the relevant costs for future movements involving access. Although specific identification and valuation of line segment assets may have been preferable to those developed on the record, we believe the interest rental result determined here is a practical approximation of the capital costs necessary to encourage UP to continue providing such assets. Furthermore, use of the industry-average current cost of capital rate is a practical alternative to the development of an individual railroad rate, absent sufficient data to do so.[7] In summary, we believe the use of the capitalized earnings approach (as modified here) represents a practical and reasonable measure of the specific assets required, or consumed, as a result of access. Sharing such identified costs between landlord (UP) and tenant (SP) on the basis of percentage usage places the parties on identical and competitive footing and

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[6] *Id.* p. 73.

[7] This conforms with RAPB's view that the industry average cost of capital is appropriate when carrier-specific data are unavailable. *Id.* at 37 and 73.

ensures continued joint provision of service and adequate reinvestment.

We find the previously approved formula for the development of trackage rights compensation (as modified in this decision) to be in conformance with the Principles established by RAPB and consistent with the guidelines for implementation set forth in its report.

B. Market Value of Road Property and Incentive Per Diem Issues. SP notes that the 1979 Annual Report Form R-1 shows road property for MP equal to 43.5% of total property. It also concludes that the market value of the MP's road property was 43.9% of total property. It reaches this conclusion by noting that UP's acquisition of MP was reflected as a "purchase" transaction under generally accepted accounting principles regarding such a transaction.[8] SP states that the use of purchase accounting produces a fair market value for MP that reflects terms agreed to between the buyer (UP) and seller (MP) in an arms length transaction. SP further argues that the purchase accounting values in the UP's 1982 Form 10-K, submitted to the Securities and Exchange Commission, show road property for MP to be 43.9% of total railroad property.[9] Finally,

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[8] The SP cites Accounting Principle Board (APB) Opinion Number 16, which they say states the fundamental of purchase accounting as "the consideration received is established by bargaining between independent parties and the acquiring corporation accounts for the additional assets at their bargained—that is, current—values." They also note that this bargained amount is referred to as the "fair value" in the remainder of APB 16.

[9] The SP computes the percentages of road, equipment, and other property from UP's 10-K data as follows:

Road	$762,962	43.94%
Rail Equipment	968,180	55.76%
Other	5,259	0.30%
Total	$1,736,401	

The figures used by the SP include both the MP and the Western

SP argues that, although these figures are as of 1982, there is no reason to believe that the relative percentages for road, equipment, and other property would be significantly different for the year 1979.

The UP contends that a detailed appraisal of the relative value of road to total property in 1979 would have provided the most accurate figures. It notes, however, that no such appraisal was performed and that it would be impractical to perform one nine years later. As a proxy for such data, the UP uses current cost data submitted by the MP in its 1979 Form 10-K under the provisions of Statement No. 33 of the Financial Accounting Standards Board (FASB 33).[10] These data show road property equal to 66.3% of total property.[11] The UP argues that the difference between the book and market value percentages is due to the fact that retirement-replacement-betterment (RRB) accounting for track was in use during that time period and that RRB accounting did not take inflation into account.[12]

Pacific (WP). The SP contends that it knows of no reason why the inclusion of the WP or the use of 1982 data in lieu of 1979 data would produce significantly different relative percentages.

[10] FASB 33 required certain publicly traded companies to provide data on a current cost basis. These data show what it would cost to replace the current investment of the company using current dollars as opposed to the book value of the investment.

[11] This percentage is developed in the MP's 1979 Form 10-K as follows:

Current cost of roadway property	$3,680.8 million
Current cost of equipment property	$1,839.7 million
Current cost of other property	$ 28.5 million
Total current cost of property	$5,549.0 million
Percentage of road to total	66.33%

[12] UP argues that under RRB accounting, no increase in value is recorded on the books when track is replaced, even though inflation had increased the price and value of the track.

In its reply statement, SP takes issue with UP's contention that FASB 33 current cost data should be used to determine the relative percentages of road, equipment, and other property on a fair market basis. SP notes that the FASB 33 current cost figures were not used to determine the fair market value of the railroad.[13] It contends that the 290 percent difference between the FASB 33 figure and the agreed-upon price produces estimates that are not very reliable. SP argues that FASB 33 was not intended to be used for the determination of market values but was merely designed to show how a company's historical costs would have been affected by inflation.

SP also notes that five track structure accounts make up over half of the total current cost number using FASB 33. It argues that these accounts were not subject to depreciation under RRB accounting and, therefore, do not reflect the used condition of these assets. Since the equipment accounts were subject to depreciation, SP argues that there is a significant inconsistency in the use of current cost accounting, namely the comparison of new equipment to used road property.

UP, in its reply, asserts that SP's argument that purchase accounting represents the market value is incorrect and that purchase accounting merely represents what it refers to as the "fair value" of MP. UP goes on to state that APB No. 16 permits many different methods to be used to develop fair value and contends that fair value and market value are not necessarily the same.

UP also argues that the values included in the Form 10-K include not only the MP railroad, but also WP and other assets of the Missouri Pacific Corporation. It asserts that, as a result, the use of these figures is suspect.

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[13] SP notes that the agreed-upon price for MP was $1.42 billion; an amount considerably less than the $5.55 billion current cost using FASB 33.

Additionally, UP contends that the figures in the 1982 Form 10-K do not relate to the values for 1979. It states that these figures tell nothing about the price that MP agreed to pay in 1979 as the result of arm's length negotiations. Finally, UP argues that if SP intends to disregard the current market prices of MP's equipment in 1979 and use current costs, it must do the same for road way property.

UP concludes that the relative values of the current market prices for MP in 1979 should be used to determine the roadway multiplier. It further concludes that SP's evidence relies entirely on the book values of this property and should not be considered.

We have reservations concerning both SP's and UP's evidence regarding the relative weights of roadway, equipment, and other property. SP's figures are based on 1982 purchase accounting, which may differ from the 1979 relative weights. UP's figures are based on current costs of road and equipment, values that are not similar to the price actually paid for MP. We recognize that the RAPB recommended that assets be valued using current market value for the specific incremental assets required or consumed as a result of access.[14] However in this case, the purchase in 1979 and the purchase accounting valuation reported in the UP's 1982 10-K are proximate enough in time to be considered a reasonable estimate of current market valuation.

The UP's contention that the relative weights of road, equipment, and other property should be based on the 1979 current cost valuation of MP is not reasonable. The current cost valuations of this property contained in the 1979 Form 10-K are three times the price actually paid for MP *and* WP combined.

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[14] RAPB Final Report at 73.

While SP uses 1982 purchase accounting values to develop the relative market value weights as of 1979 and ignores any difference that might have occurred in that three-year time period, these 1982 purchase accounting values do reflect the actual purchase price for MP when the merger was completed. Any differences between 1982 purchase accounting figures and those that would have existed in 1979 are far smaller than the difference between the current cost valuation and the purchase price of MP. Thus, while SP's figures may result in a relative market weight for roadway property in 1982 that would be different from the relative market weight in 1979, the difference is slight; it is far less significant than the enormous difference that exists when current cost valuations are used. We therefore conclude that SP has provided the best evidence of record, and hold that a roadway multiplier of 43.9% be used, based on the purchase accounting as shown in UP's 1982 Form 10-K.

Both parties agree that an additive for incentive per diem is appropriate. However, the calculations of the parties are different because SP has added steps to the applied methodology.[15] We believe that SP's adjustment of the $28,689 expense in the MP study to $29,753 is warranted and it reflects an accurate estimate.[16] However, the subsequent adjustment (which more than doubles this amount to a total of $64,230) has not been justified.[17]

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[15] UP calculates incentive per diem at $28,689. SP calculates it to be $64,230.

[16] The SP study version incorporates two major refinements which enlarge the IPB estimate. First, SP has refined the car-type study initially introduced in evidence by stratifying the data so as to reflect the weighing of incentive per diem for the different car types. This step appears to constitute a desirable refinement. It accounts for a minor portion of the expense variance.

[17] SP's other adjustment is not so distinct. Its witness alleges at 2 of his statement that the Kauders (MP) study is deficient for its failure

The impact of the adoption of this expense factor on the values appearing in our earlier analysis of the trackage rights evidence would be to increase total adjusted costs, thereby reducing the line-specific combined earnings. *Compensation II, supra,* at 684, found the line earnings to be $18,287,939. This amount is reduced by the IPD expense factor of $29,753 to produce line earnings of $18,258,186.

C. Petition to Reopen. On February 22, 1988, SP petitioned the Commission to reopen these proceedings. SP requested that we reverse our decision to base track rental charges on the current cost of capital. Alternatively, SP requested that we provide another opportunity to submit supplemental evidence supporting the claim that interest rental charges are more appropriately based on the actual return being earned by the landlord railroad.

SP makes four basic arguments: (1) cost of capital is inappropriate because it upsets the principle of competitive equality upon which approval of the merger was based; (2) changing the "economic logic" from our "holding" in the consolidation decision would be arbitrary and capricious; (3) using a floating rate of return as an alternative does not lock UP into an inadequate return; and (4) if cost of capital is used, SP must be allowed to submit additional evidence concerning the effects of such use on line competition. We will address each argument in turn.

SP argues that the principle of "competitive equality" is being breached because basing interest rental charges

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to adhere to "normal Rail Form A rental procedure", specifically because the approach taken "* * * includes earnings of system cars but excludes the car days of system cars * * * assignable to the Kansas City-St. Louis line * * *." Rail Form A basically provides that system-wide net debit balances (where payables exceed receivables) are to be further processed in the formula; such balances are to be combined with all other equipment maintenance expenses. The Rail Form A unit car costs, which reflect these IPD net debit balances, may then be applied for costing any movements hauled in railroad owned cars, whether system or foreign. *See* Appendix.

on cost of capital would force SP to pay UP more than UP charges shippers on the line. SP states that this would defeat the Commission's purpose in conditioning the merger.

The SP includes a table showing that the pre-tax rate of return for the MP (1983 through 1985) was between 25 and 33% of the cost of capital rate, and that the 1986 rate of return for the UP was slightly more than half the cost of capital rate. It also includes a table showing that the SP would have to pay a higher charge than the implicit charge to the UP/MP for traffic moved over this line.[18]

As we stated in *Compensation II, supra,* at 682, a goal of the national rail transportation policy is to "promote a safe and efficient rail transportation system by allowing carriers to earn adequate revenues, as determined by the Interstate Commerce Commission * * *" 49 U.S.C. § 10101a(3). We must aid rail carriers in attaining revenues sufficient to cover total operating expenses plus a reason-

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[18] We have consolidated these tables as follows:

Year	Pre-Tax Cost Of Capital	Pre-Tax UP/MP Rate Of Return	Charge to SP Based on Cost Of Capital	Implicit Charge to UP/MP Based on UP/MP Rate of Return
1983	25.40%	6.38%	$52.89	$13.28
1984	25.52%	6.34%	$53.14	$13.20
1985	22.39%	7.57%	$46.62	$15.76
1986	19.13%	10.50%	$39.83	$21.86

These numbers assume that MP or UP will run 220,000 carloads per year over the line and that SP will run 74,000 carloads per year over the line. They also assume no loss of traffic from the UP/MP to the SP and a roadway line value (based on the SP's computation of a road multiplier) of $61.63 million. The charges are computed by multiplying the road value by the appropriate return factor (cost of capital rate for SP, or UP/MP rate of return for UP/MP) and dividing the result by the total number of carloads moving over the line (294,000).

able return on capital raised, in order to maintain the enterprise. 49 U.S.C. § 10704(a)(2). A return on investment consistently lower than the cost of capital presages corporate contraction since both debt and equity investment alternatives are comparatively more attractive. As a result, a return on investment for trackage use that is below the cost of capital perpetuates insufficient long-term investment, thereby rendering a railroad revenue inadequate.

Moreover, there are sound practical reasons for using the current cost of capital. Its use favors no carrier over another and places both the incumbent and tenant railroads on identical footing. *Compensation II, supra,* at 682. Both railroads share the ownership costs of the line fairly. Using cost of capital also prevents "railroad shopping" where a carrier with a low return on investment is an attractive trackage rights target. *Id.* In addition, its use ensures that the renting railroad is not subsidized by the owning railroad. *Id.* Cost of capital is used in abandonment and rate prescription proceedings in the absence of justification for some other figure. *Id.*

SP states that using cost of capital rather than rate of return puts SP in an inferior position because it will pay more than UP's customers; as a result, SP argues, the purpose of the trackage rights granted as a condition to the merger is defeated. We disagree. We recognize that, although we have broad power to impose conditions to ameliorate anticompetitive effects, such conditions may lessen the benefits of a consolidation to both the involved carriers and the public. *Norfolk Southern Corp.-Control-Norfolk & W Ry. Co.*, 336 I.C.C. 171, 235 (1981). Therefore, we do not normally impose conditions that would frustrate the ability of the consolidated carrier to obtain the anticipated public benefits from the consolidation. *Id.* To force UP to subsidize its competitor SP would frustrate its ability to obtain sufficient benefit from the merger.[19]

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[19] We note that use of the floating UP rate of return (*see infra*)

Contrary to SP's assumption, using cost of capital does not defeat the purpose of the trackage rights granted as a condition to the merger. SP receives enormous quantitative and qualitative benefits as a result of this trackage rights grant. SP has long sought direct access between Kansas City and St. Louis to cut approximately 400 miles off the length of its transcontinental route between the West Coast and St. Louis. *Compensation I, supra,* at 796; *see e.g., St. Louis S.W. Ry.-Purchase-Rock Island (Tucumcari),* 363 I.C.C. 323 (1980); and *Norfolk Southern Corp.-Control-Norfolk & W. Ry. Co.,* 366 I.C.C. 171 (1982). This grant should allow SP to realize substantial operational savings on West Coast-St. Louis shipments. SP also gains strategically since its position as a transcontinental carrier is enhanced. As we stated in *Compensation I,* "SP, with these trackage rights, has a greater ability to attract traffic to its lines, either for single-line SP movements between the St. Louis gateway and the West Coast or in conjunction with DRGW in the control corridor." *Id.* at 796.

Furthermore, if SP were to construct its own line from Kansas City to St. Louis in order to garner these benefits, it would not pay its own rate of return to investors. It would be forced to pay the cost of capital because neither debt nor equity capital markets would accept less.

By using the UP Kansas City-St. Louis line, SP need not incur the initial investment cost of constructing its own Kansas City-St. Louis line. It is highly unlikely that the net present value of the stream of interest rental payments payable at a cost of capital rate would even begin to approach the capital investment cost of constructing a comparable line. By this standard, SP's track-

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could, in certain circumstances, produce unreasonable results. For example, should the UP experience losses on a system basis, under SP's argument no rental charge (other than its share of maintenance and variable costs) would be required at all.

age rights grant is a special benefit.[20] SP also need not convince potential institutional investors that such a capital investment is viable.

We also recognize that the UP was either paying or foregoing the cost of capital when it decided to seek a merger with MP. If UP financed the consolidation, it must have done so by paying the cost of capital based upon a chosen debt-equity mix. Even if UP paid only cash, it would still be incurring the opportunity cost of alternate investment. We see no reason to hold that SP should pay less than the price UP paid when it purchased the line. Any other result changes the true market value of the line as reflected in the UP purchase price for MP.

SP also argues that our decision to adopt a cost of capital approach is arbitrary and capricious because we "changed the economic logic" during the course of the proceedings. SP misconstrues the nature of our approach.

SP states that "the Commission's 1982 decision [the consolidation decision] * * * held that competition would be on equal terms only if rental was determined with reference to actual return." SP petition at 9. However, we never *held* that trackage rights compensation should be based upon actual rate of return. We did state that:

> * * * [i]*n order to facilitate the negotiation of agreements* * * * [We] will set forth general principles regarding just and reasonable compensation * * * we will be guided by the following principles in setting * * * compensation * * * [A] rate of return based on current cost of capital or opportunity cost *may not be reasonable.* In

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[20] SP is also silent on the cost of its alternative to the use of these trackage rights: the rehabilitation of the old Rock Island line between St. Louis and Kansas City. It is quite likely that the payment of trackage rental would be less than the cost of rehabilitating hundreds of miles of track using a more circuitous route.

> order to provide a realistic opportunity to compete, the trackage rights tenant should operate over the involved lines under economic conditions comparable to the landlord's. Therefore, the landlord's actual rate of return on the value of its rail properties *should be given consideration* in determining a just and reasonable rate of return.

366 I.C.C. at 589-90 (emphasis supplied).

SP argues that the Commission has a duty to provide a reasoned analysis "in explaining the reversal of its prior decisions in this case." SP petition at 12, n. 5. In *Compensation I*, we did adopt actual rate of return as part of our compensation formula. And in *Compensation II*, at 681-84, we outlined quite clearly our reasons for implementing a cost of capital approach. In prefacing our discussion, we noted that our affirming the capitalized earnings approach with modifications, including cost of capital, was (b)ased on the pleadings and our own reconsideration of the issue of trackage rights compensation * * *." *Id.* at 674. We have noted those reasons, *supra*. We stated: "perpetuating, without valid reason, a return that is insufficient in the long run to allow for adequate reinvestment is not justified." *Id.* at 682.

SP implies that the Court of Appeals was willing to uphold the consolidation decision without knowing the terms of trackage rights compensation only if the Commission adopted the rate of return formula. SP petition at 6 [citing *Southern Pacific Transportation Co. v. ICC*, 736 F.2d 708, 721 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1208 (1985)]. However, the court also stated that the issue of trackage rights "involved the kind of 'judgmental or predictive' conclusion with respect to which judicial deference to agency expertise is especially appropriate." *Id.* at 721. The Commission has "extraordinarily broad discretion to impose protective conditions * * * and courts have appropriately given the Commission's selection of such con-

ditions great deference." *Id.* We see no reason to accept petitioner's narrow reading of the court's decision.

SP declares that "the landlord need not be locked into an inadequate return if the rental is allowed to vary with changes in expected actual return." Therefore SP argues that a floating rate would allow UP "to move toward revenue adequacy at the same pace as the system generally." *Id.* at 14. This solution does not address the fundamental problem of cross-subsidization in the event that UP is not revenue adequate. It also does not consider the basic principle involved: where the rate of return is less than the cost of capital, the landlord derives insufficient revenue from the line to reinvest adequately in its maintenance and operation.

SP itself identifies another problem with this approach. It is not "administratively practical to determine the expected and actual return on the line each year," therefore a system-wide expected rate of return must be used. *Id.* at 14, n. 6. However, a system-wide rate of return does not truly estimate the UP cost for maintenance and operation of the Kansas City-St. Louis line, nor does it eliminate UP's rate of return on the line. We believe that this proposal does not provide a more accurate measure of the line's cost.

SP states that "if the Commission intends to abandon competitive parity * * * and to use cost of capital, it must reopen the record to permit SP to make a showing about the serious effect of that compensation formula * * * ." *Id.* at 15-16. SP declares that, unless the proceedings are reopened, it will not have had a sufficient opportunity to be heard on this issue. *Id.* at 17. It argues that the factual record before the Commission is insufficient and "does not meet the *Florida East Coast* test for the resolution of adjudicatory issues." *Id.* at 21.

We see no contradiction between the establishment of an adequate evidentiary record and our actions in this

case.[21] This proceeding has continued for six years. The interest rental issue has been extensively addressed by numerous parties. Both SP and UP have had ample opportunity to promote their respective positions on the relative merits of a rate-of-return versus a cost-of-capital approach. It is clearly within our prerogative to refrain from reopening a proceeding. *Bowman Transportation Company, Inc. v. Arkansas Best-Freight System, Inc.*, 419 U.S. 281, 296 (1974); *Union Mechling Corp. v. United States*, 566 F.2d 722, 726 (D.C. Cir. 1977); Finance Docket No. 30,300, *CSX Corporation-Control-American Commercial Lines, Inc.*, (not printed) served July 29, 1987. Therefore, we decline SP's request to reopen this proceeding on the interest rental issue.

COMMISSIONER LAMBOLEY, dissenting:

I reaffirm my position that I would have continued the use of the actual rate of return of the MP, rather than the pre-tax cost of capital, in the interest compensation formula. In my view, the MP is not entitled to a rate of return at a level that has never been achieved in its operations. The MP is not a utility, but use of "industry average" figures for rates of return accord it such status for compensatory purposes.

Furthermore, these trackage rights were granted to the SP to preserve competition and to ameliorate the anti-competitive effects of the consolidation of UP-MP-WP. The

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[21] *Florida East Coast* held that the Interstate Commerce Act's Sec. 1(14)(a) hearing requirement did not trigger a trial-type hearing and that only notice was required prior to rulemaking. *United States v. Florida East Coast Railway Co.*, 410 U.S. 224, 244-46 (1972). That case and its progeny concern only adjudicatory agency action where the agency did not provide a reasoned basis for its decision or could not develop a record sufficient enough to carefully decide the issue. *See, e.g., Illinois Central Gulf R.R. v. ICC*, 717 F.2d 408, 412 (7th Cir. (1983); *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519, 549 (1978).

imposition of the interest compensation formula adopted by the majority disproportionately favors the MP and handicaps the SP's ability to offer the competitive service envisioned by the Commission as an effective condition to the consolidation. The use of the pre-tax cost of capital in the compensation formula thus may defeat the purpose of the award of trackage rights.

It is ordered:

1. A roadway multiplier of 0.439 and an incentive per diem of $29,753 shall be used in determining interest rental under the capitalized earnings formula employed in *Compensation II* for the Kansas City-St. Louis line segment.

2. The petitions to reopen this proceeding filed by Southern Pacific Transportation Company and St. Louis Southwestern Railway Company and the UP are denied.

3. This decision is effective on June 5, 1989.

By the Commission, Chairman Gradison, Vice Chairman Simmons, Commissioners Andre, Lamboley, and Phillips. Commissioner Lamboley dissented with a separate expression.

APPENDIX

	Base Traffic	TDS Traffic	Total THS Cost	Net Ratio To Net	Ratio Amount Foreign Only	Total RR Total to Fgn. (Tbl. B)	Owned Net Incentive Per Diem
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
1. Box Plain 40 foot	$ 3,891	$ 1,624	$ 5,515	.35	$ 1,930	1.93	$ 3,725
2. Box Plain 50 foot	129,092	97,926	227,018	.27	61,295	1.93	118,299
3. Box Equipped 40' XF	260	0	260	.12	31	2.04	63
4. Box Equipped 50' XF	12,187	0	12,187	.12	1,462	2.04	2,982
5. Plain Gondola	31,883	12,944	44,827	-.78	(34,965)	1.74	(60,839)
6. Totals	$177,313	$112,494	$289,807	.102	$29,753		
7. Net IPD							$ 64,230

The SP figures (columns a and b) comprise all identified incentive per diem payable by MP on foreign cars it handles over the KC-ST.L corridor, *i.e.*, these amounts are purely debits in MP's books. A multiplication of the totals (column c) by the MP system ratios of net incentive per diem to the payable portion (column d) offsets these debits in accordance with Rail Form A theory and provides net amounts (column e). At this stage, Table A has accounted for both the payables (debits) and the offsetting receivables (credits), collectively totalling $29,753 on line 6. It is true that in Rail Form A applications (wherein it may not be known for given movements whether a foreign or a system car will be utilized), unit costs reflect both classes of ownership, *i.e.*, net debit. However, any further adjustment of the total net incentive per diem expense (column e) on this specific corridor to incorporate an on-line system car experience (columns f and g) will overstate the net IPD. The procedures leading to the figures in column (e) already have established the correct total incentive per diem expense assignable to the Kansas City-St. Louis corridor.

ST. LOUIS SOUTHWESTERN RY. CO. COMPENSATION-TRACKAGE RIGHTS

FINANCE DOCKET NO. 30000 (SUB-NO. 16)

ST. LOUIS SOUTHWESTERN RAILWAY COMPANY-TRACKAGE RIGHTS OVER MISSOURI PACIFIC RAILROAD COMPANY-KANSAS CITY TO ST. LOUIS

Decided August 15, 1991

In three prior decisions in this proceeding, the Commission established the basic framework for the calculation of the interest rental component of the trackage rights compensation owed to Union Pacific Railroad Company (UP) for the Kansas City-St. Louis trackage rights awarded to Southern Pacific Transportation Company (SP)in the 1982 *UP/MP/WP case.* In the present decision, the Commission clarifies four technical issues not explicitly considered in the prior decisions.

BY THE COMMISSION:

In *Union Pacific-Control-Missouri Pacific; Western Pacific,* 366 I.C.C. 459 (1982), we conditioned our approval of the UP/MP/WP consolidation upon the grant to an SP subsidiary of trackage rights over UP's Kansas City-St. Louis lines. In *St. Louis Southwestern Ry. Co. Compensation-Trackage Rights,* 1 I.C.C.2d 776 (1984), 4 I.C.C.2d 668 (1988), and 5 I.C.C.2d 525 (1989), (*Compensation I, Compensation II,* and *Compensation III,* respectively), we established the basic framework for the calculation of the interest rental component of the trackage rights compensation accruing to UP with respect to these trackage rights. In the present decision, we are clarifying four technical

issues with regard to the calculation of the interest rental component of the trackage rights compensation.

BACKGROUND

In 1982, we approved an application seeking authorization for the control, by Union Pacific Corporation (UPC) and Union Pacific Railroad Company (UPRR), of Missouri Pacific Railroad Company (MPRR) and Western Pacific Railroad Company (WPRR). *Union Pacific-Control-Missouri Pacific; Western Pacific,* 366 I.C.C. 459 (1982) (*UP/MP/WP*).[1] Recognizing, however, that such approval, if unconditioned, threatened to eliminate existing intramodal rail competition in the Central Transcontinental Corridor, we conditioned our approval of the UP/MP/WP consolidation upon the grant of certain trackage rights to Denver and Rio Grande Western Railroad Company (DRGW) and to St. Louis Southwestern Railway Company (SSW), a subsidiary of SP.[2] In particular, SSW was granted trackage rights over MPRR's lines between Kansas City and St. Louis. *UP/MP/WP, supra,* at 585-589.

We were aware at the time that the various railroads had not yet negotiated agreements covering these trackage rights grants. Preferring negotiated agreements to imposed agreements, we urged the parties to negotiate their own agreements, and thereafter to submit them for our approval. In order to facilitate the negotiation of agreements, we set forth "the general principles regarding just and reasonable compensation for trackage rights imposed in consolidation proceedings." We indicated that we would be guided by these general principles in setting trackage

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[1] The surviving corporate entities (UPC, UPRR, and MPRR) are referred to collectively as UP.

[2] In general, SP and SSW are referred to collectively as SP.

rights compensation absent a voluntary agreement. *UP/MP/WP, supra,* at 589-590.[3]

The *UP/MP/WP* decision was challenged on appellate review on various grounds. In particular, SP challenged our failure to fix the terms under which UP would be paid for the use of its track, and argued that, because the level of compensation had not been fixed, it was impossible to tell whether SP's trackage rights operations would be competitive with UP's operations. The challenge was rejected. *Southern Pacific Transp. Co. v. I.C.C.*, 736 F.2d 708, 721 (D.C. Cir. 1984) ("[W]e trust the Commission to ensure that the compensation terms will not defeat the purpose of the trackage rights. The ICC has in fact guaranteed that it will see to the proper functioning of the trackage rights." Citation omitted), *cert. denied,* 469 U.S. 1208 (1985).

In March 1983, after SP's trackage rights operations began[4] and while the court challenge was pending, UP and SP, unable to reach a negotiated agreement on the "interest rental" component of trackage rights compensation,

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[3] Two of these general principles have been referenced numerous times in the course of this proceeding. (1) "In order to provide a realistic opportunity to compete, the trackage rights tenant should operate over the involved lines under economic conditions comparable to the landlord's." *UP/MP/WP, supra,* at 590. (2) "[T]hese trackage rights are granted for the purpose of maintaining competitive balance * * *. Therefore, any terms so onerous to the tenant as to defeat the purpose of the trackage rights cannot be considered just and reasonable." *UP/MP/WP, supra,* at 590 (citation omitted).

[4] The *UP/MP/WP* decision envisioned that trackage rights operations could commence prior to the establishment of compensation terms. "[I]mmediately upon consummation of the consolidations, the imposed trackage rights will become effective and trackage rights tenants will have authority to commence operations. Compensation, which will accrue from the actual date of the start of trackage rights operations, will be payable after terms have been determined." *UP/MP/WP, supra,* at 590.

petitioned us to establish terms.[5] In decisions served in 1984, 1988, and 1989, we established the basic framework for the calculation of the interest rental component of trackage rights compensation.

The basic framework established in the three *Compensation* decisions provides for interest rental to be calculated by multiplying the computed valuation base[6] by the pre-tax railroad cost of capital. The product of that calculation (which is, in effect, an annual interest rental figure applicable to both railroads using the lines) is divided by 12 to put it on a monthly basis. For any particular month, the figure last arrived at is multiplied by a percentage representing SP's usage of the lines for that month.[7] Interest on unpaid amounts is calculated using the pre-tax railroad cost of debt.

The *Compensation III* decision was served on June 5, 1989. Neither UP nor SP sought administrative reconsideration of that decision. Neither party made any filings in this proceeding for 14 months following the service of the *Compensation III* decision. Instead, both parties filed for review in the United States Court of Appeals for the District of Columbia Circuit.[8]

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[5] There are several components of trackage rights compensation. The key ones are: interest rental (which may be viewed as an allocated share of opportunity costs or fixed costs); variable costs associated with SP's operations; and a usage-based share of expenses for maintenance, operations, taxes, and assessments. The interest rental component is the one that the parties have not been able to agree upon.

[6] The computed valuation base, reflecting the 1979 value of the road property, is $62,077,832.40. This is calculated by multiplying the $18,258,186 line earnings by a 3.4 earnings multiple.

[7] SP's usage is calculated on a monthly basis, and then recalculated on a 36-month rolling average basis.

[8] Three petitions for review have been filed in the D.C. Circuit, and have been consolidated by order of the court. Two of these petitions (SP's, filed July 20, 1989, and UP's, filed August 4, 1989) were filed

It thereafter became apparent, however, that the parties could not agree as to the precise holdings of our *Compensation* decisions. In September 1989, UP presented SP with a bill calculating the retroactive payments due for the period from January 1983 through June 1989. Every few months since September 1989, UP has presented SP with an updated bill, adding in the new retroactive payments generated over the intervening months. In May 1990, SP came forward with its own calculations. The two sets of calculations, both purporting to adhere to the *Compensation I, II,* and *III* methodology, differ substantially. Each party, in making its calculations, uses certain technical assumptions that it claims are consistent with, and indeed are required by, the prior decisions. In four crucial particulars, however, the technical assumptions utilized by UP differ from those utilized by SP.[9]

On August 15, 1990, UP filed a petition for clarification of these four matters. On September 4, 1990, SP filed a reply. Both parties seek clarification of the prior decisions issued in this proceeding.[10]

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soon after the service of the *Compensation III* decision; one of these petitions (UP's, filed March 8, 1988) had been filed after the service of the *Compensation II* decision. The lead court proceeding, which is the one that was instituted after the *Compensation II* decision was issued, is No. 88-1186, *Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company v. Interstate Commerce Commission and United States of America.*

[9] Each party, although making its calculations in accordance with its understanding of the proper interpretation of the formula established in the *Compensation* decisions, intends nonetheless to preserve its rights to pursue its appellate challenges to various aspects of the *Compensation* decisions.

[10] By order filed September 10, 1990, the D.C. Circuit granted a motion filed by SP to hold the judicial review proceeding in abeyance pending our disposition of the petition for clarification.

THE PURPOSE OF THE SP TRACKAGE RIGHTS

In the 1982 *UP/MP/WP* decision, DRGW was granted trackage rights between Pueblo and Kansas City, and SP was granted trackage rights between Kansas City and St. Louis. These grants were designed with two different ends in mind. First, the grants were designed to mitigate competitive harms that might otherwise have resulted in the Central Corridor as a consequence of the UP/MP/WP consolidation. Second, the grants were designed to mitigate competitive harms that might otherwise have resulted in the transcontinental market in general as a consequence of the UP/MP/WP consolidation, taking into consideration both the Central Corridor (SP/DRGW/SP joint-line service) and the Southern Corridor (SP single-line service). *UP/MP/WP, supra,* at 586-587.

> The SP trackage rights will serve the public interest by resulting in savings of rehabilitation funds [this had reference to the estimated $100 million cost of rehabilitation of the Kansas City-St. Louis line formerly owned by the Rock Island and recently acquired by SP, 366 I.C.C. at 586], fuel savings (SP's Tucumcari route between southern California and St. Louis is 400 miles shorter than its Corsicana route), and the enhancement of competition for transcontinental traffic in general which we have found to be adversely affected by consolidation. Along with DRGW's trackage rights between Pueblo and Kansas City, SP should be able to provide excellent service for its captive California shippers, and a competitive alternative to UP for most central corridor shippers, in a manner which causes a minimal burden on applicants and other carriers.
>
> As discussed in our section on essential service and our analysis of SP's spiral down theory (Appendix F-9), SP's ability to provide essential services is not significantly threatened by this consolidation to itself

> justify the imposition of conditions. We are granting SP's trackage rights to mitigate competitive harms resulting from the consolidations, that is, a reduction in rail competition in the central corridor and for transcontinental traffic in general.

UP/MP/WP, supra, at 588-589.[11]

In granting DRGW trackage rights over UP's Pueblo-Kansas City line, and in granting SP trackage rights over UP's Kansas City-St. Louis lines, we intended to mitigate the loss of competition that the UP/MP/WP consolidation might otherwise have occasioned. The pre-consolidation competition had included, among other things, an SP/DRGW/MP Central Corridor routing and an SP/MP Southern Corridor routing. Fearing that the vertical foreclosure effect of consolidation would remove MP from these routings, we granted trackage rights that would have the effect of recreating these routings with DRGW (Pueblo-Kansas City) and SP (Kansas City-St. Louis) substituted for MP. By granting trackage rights, we had removed the enormous barrier costs that would otherwise have prevented DRGW and SP from entering this market.[12] With trackage rights thus granted and available for use, DRGW and SP could enter this market at their convenience.

The Commission granted SP trackage rights in the belief it would use them, and indeed it has done so. The Com-

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[11] *See also UP/MP/WP;, supra,* at 589: "We impose these trackage rights conditions [including, among others, SP's trackage rights] in order to preserve the competitive balance in transportation markets where competition might otherwise be significantly lessened as a result of the consolidations."

[12] Even in terms of 1982 dollars, the barrier costs involved in creating a new rail line running from Pueblo to Kansas City and on to St. Louis were no doubt large. For the Pueblo-Kansas City segment, no estimate has been provided. For the Kansas City-St. Louis segment, an estimate of $100 million has been provided for the mere rehabilitation of the SP's former Rock Island line.

mission's decision, however, did not *require* SP to operate those trackage rights. Had SP chosen not to operate the trackage rights, it would not have stood as an impediment to the consummation of the UP/MP/WP consolidation. We would not have permitted a third party opponent to the proposed consolidation to block the consolidation in this manner.

Similarly, we will not permit a transaction we approved as in the public interest to be held hostage to a dispute over the compensation to be paid for SP's operation over MP's lines. In permitting the transaction to go forward without the compensation issue resolved, we guaranteed that if we were required to set compensation because of the inability of the parties to agree, the terms of the trackage rights would not be "so onerous to the tenant as to defeat the purpose of the trackage rights," *UP/MP/WP, supra,* at 590, and *Southern Pacific, supra,* at 721. We did not represent that we would establish terms so favorable to SP as to ensure their willingness to operate the rights we provided. The methodology we have developed in the *Compensation* decisions, as clarified here, establishes reasonable terms for SP's use of the involved trackage rights. SP has no right to expect us to establish compensation on a basis that is less than reasonable. Our refusal to do so can hardly be deemed "to defeat the purpose of the trackage rights." The competitive opportunity created by the trackage rights grant was intended to mitigate the competitive harms that might otherwise have been occasioned by the UP/MP/WP consolidation.[13]

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[13] "We have said on numerous occasions that we protect competition, not competitors." *Union Pacific Corp. et al.-Cont.-MO-KS-TX Co. et al.*, 4 I.C.C.2d 409, 460 (1988). "Our primary concern is protecting competition. Transfers of traffic among competing carriers are not grounds for rejection of a proposal or imposition of conditions unless a carrier's ability to provide essential services is threatened." *Rio Grande Industries, Et Al.-Pur. & Track-CMW Ry. Co.*, 5 I.C.C.2d 952, 968 (1989). "[A] showing of expected substantial harm to a particular *competitor*

DEVELOPMENT OF THE COMPENSATION FORMULA

When UP and SP were unable to agree on the interest rental component of trackage rights compensation, the matter was brought before us for resolution. In developing a formula by which a dollar valuation might be placed upon the interest rental component, we needed to adopt a compensation formula low enough to permit SP to offer an effective competitive alternative if UP were to engage in monopolistic pricing practices. On the other hand, the compensation formula could not be set too low. The compensation formula also had to be high enough so as not to eliminate UP's incentive to maintain the route in first class operating condition. That would not be fair to UP, and might even undercut the effectiveness of UP's own operations.

In the 1982 *UP/MP/WP* decision, in setting forth the principles by which we would be guided in setting trackage rights compensation absent a voluntary agreement between the parties, we attempted to strike a balance between the two competing concerns.

> The landlord railroad clearly is entitled to recover from the tenant full compensation for all variable costs incurred by the landlord as a result of the tenant's trackage rights operations. Further, the landlord should be entitled to recover an allocated share of its fixed costs relating to the involved trackage. We prefer that these costs be allocated on an actual use basis

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as a result of a transaction is not equivalent to a showing of harm to *competition*. For example, a rail or truck competitor might lose traffic precisely because a transaction promises the significant public *benefit* of a new, improved transport alternative. Harm to the competitor would not be grounds for rejection of a proposal or imposition of conditions unless a carrier's ability to provide essential services is threatened." *Rio Grande Ind., Inc.-Pur. & Track-Soo Line R. Co.*, 6 I.C.C.2d 854, 875 (1990) (emphasis in original). *See also Canadian Pacific Ltd.-Pur. & Trackage-D&H Ry. Co.*, 7 I.C.C.2d 95, 112 (1990).

unless some other method is shown to be more equitable. In addition to recovery of costs, the landlord should receive rent for the use of its property. Rent should be based on an allocated share of return on value of the property. Valuation of the property should be the current fair market value, rather than book value or replacement value. Parties may determine rate of return on any reasonable basis. With respect to existing rail properties, absent new capital investment relating to the trackage rights operations, a rate of return based on current cost of capital or opportunity cost may not be reasonable. In order to provide a realistic opportunity to compete, the trackage rights tenant should operate over the involved lines under economic conditions comparable to the landlord's. Therefore, the landlord's actual rate of return on the value of its rail properties should be given consideration in determining a just and reasonable rate of return.

Finally, in setting compensation terms absent voluntary agreement, we will consider the factor that these trackage rights are granted for the purpose of maintaining competitive balance where competition would otherwise be significantly lessened by the consolidations. Therefore, any terms so onerous to the tenant as to defeat the purpose of the trackage rights cannot be considered just and reasonable. [Citation omitted.]

UP/MP/WP, supra, at 589-590.

In the three *Compensation* decisions, we developed a trackage rights compensation formula based on the *UP/MP/WP* principles. We developed a formula to inhibit any exercise of monopolistic power by UP. We intended that the formula would produce an interest rental payment low enough to achieve this purpose, but no lower. We never expressed an intent that the trackage rights compensation

formula in general, or the interest rental component thereof in particular, would forever be kept low enough to guarantee that SP would choose to conduct trackage rights operations on the Kansas City-St. Louis lines.[14] We cannot guarantee that economic circumstances will be such that even UP, the owner of the line, will actually conduct rail operations over it.

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[14] Since our approval of the UP/MP/WP consolidation, the competitive and operating environment of the railroads involved have changed substantially. In 1982, SP and DRGW were under separate ownership, and SP did not have direct access to Chicago. In *Rio Grande Industries, et al.-Control-SPT Co., et al.*, 4 I.C.C.2d 834 (1988), we approved an application filed by Rio Grande Industries, Inc. (RGI) and its wholly-owned DRGW subsidiary to acquire and exercise control over SP and its carrier subsidiaries. In *Rio Grande Industries, et al.-Pur. & Track-CMW Ry. Co.*, 5 I.C.C.2d 952 (1989), we approved an application filed by RGI, SP, DRGW, SSW, and a newly formed RGI subsidiary to acquire the Chicago, Missouri & Western Railway Company line between East St. Louis and Chicago. In Finance Docket No. 31730, *Rio Grande Industries, Inc., Southern Pacific Transportation Company, The Denver and Rio Grande Western Railroad Company, St. Louis Southwestern Railway Company, SPCSL Corp.—Trackage Rights—Burlington Northern Railroad Company Lines Between Kansas City, MO and Chicago, IL* (not printed), notice of exemption served October 26, 1990, SP, DRGW, SSW, and a newly formed RGI subsidiary were granted overhead trackage rights over the lines of Burlington Northern Railroad Company (BN) between Kansas City and Chicago. As a consequence of these proceedings, SP and DRGW are now under common ownership, and SP now has direct access to Chicago (from Kansas City via trackage rights over BN, and from E. St. Louis via its own line). Neither party to the present proceeding has suggested that these changes should have any impact in the determination of the trackage rights compensation formula applicable to the Kansas City-St. Louis trackage rights awarded to SSW in the *UP/MP/WP* case and accordingly we will not undertake to factor them into our analysis. Their existence, however, cannot be denied, and supports our attempt to establish a compensation formula which is reasonable as opposed to attempting to create one that would have been appropriate under the circumstances that existed at the time the UP/MP/WP consolidation was approved.

COMPENSATION I

In *Compensation I,* we sanctioned a capitalized earnings methodology as the methodology by which the interest rental component of trackage rights compensation would be determined. As a general proposition, interest rental would be computed by multiplying the value of the Kansas City-St. Louis lines by the Missouri Pacific Corporation's 1979 pretax rate of return.[15] As a practical matter, this involves a four-step approach.

First: A 1979 earnings multiple was calculated for MPC. The earnings multiple, which relates corporate value to corporate earnings, represents the ratio of MPC value (outstanding liabilities plus stock purchase price) to 1979 MPC earnings. These calculations generated a 5.47 earnings multiple. *Compensation I, supra,* at 787-788.[16]

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[15] MPRR was a subsidiary of Missouri Pacific Corporation (MPC).

[16] In *Compensation I,* in adopting the earnings multiple approach for the determination of the value of the investment base, we described the earnings multiple approach as the most appropriate technique for valuing railroad assets in the trackage rights context. "[T]his method is predicated on the carrier continuing as a going concern. This characteristic is perhaps the methodology's greatest advantage in valuing assets using [sic] in trackage rights operations * * *. The purpose of this proceeding is to set compensation for the trackage rights which will put the tenant in the same position as the owning carrier." *Compensation I, supra,* at 786. UP had suggested, in place of the earnings multiple approach, the use of an RCNLD (reproduction cost new less depreciation) approach. We rejected the RCNLD approach, saying: "The RCNLD approach does not value the asset as a going concern business, but rather solely as individual parcels of land and specific existing structures. This is not to say that RCNLD valuation is inappropriate in other contexts, or that the methodology used here is appropriate outside the immediate setting where trackage rights have been imposed to remedy anticompetitive effects of a consolidation. Where we are attempting to place the tenant in precisely the position of the owning road, however, the earnings multiple approach is more appropriate." *Compensation I, supra,* at 786.

Second: The investment base, *i.e.*, the value of the Kansas City-St. Louis lines, was to be determined by multiplying the 1979 earnings of these lines by the earnings multiple. As no earnings figures were then available for these lines, the parties were directed to submit such figures. *Compensation I, supra,* at 780.

Third: The total return on the Kansas City-St. Louis lines would then be determined by multiplying the investment base by MPRR's 10.21% 1979 pretax rate of return on investment (which was calculated using MPRR's effective tax rate, not the statutory tax rate). *Compensation I, supra,* at 789, 801.

Fourth: Interest rental owed by SP to UP would then be determined by multiplying the total return on the Kansas City-St. Louis lines by SP's usage share.[17]

COMPENSATION II

In *Compensation II,* we affirmed the basic capitalized earnings methodology of *Compensation I,* while making certain changes in each element of the four-part formula.[18]

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[17] In thus calculating the interest rental component of trackage rights compensation, we made many references to the principle that trackage rights terms so onerous to the tenant as to defeat the purpose of the trackage rights could not be considered just and reasonable. "Each grant of these trackage rights [DRGW's Pueblo-Kansas City trackage rights; SP's Kansas City-St. Louis trackage rights; and MKT's Kansas City-Omaha/Council Bluffs trackage rights] was designed to remedy a specific anticompetitive effect of the consolidation. However, we recognize that the key to the success of the conditions lies in the terms of compensation for use of the trackage rights." *Compensation I, supra,* at 779. "[The SP] trackage rights have been imposed by this agency to ameliorate the anticompetitive effects of [the] consolidation. We will not allow the consolidated UP/MP system to defeat that competition by extracting rents for these lines that reflect the value of SP/SSW operations." *Compensation I, supra,* at 801. "[W]e remain concerned that SP be able to operate with a cost structure competitive to that of the UP on these lines." *Compensation I, supra,* at 802 (footnote omitted).

[18] We noted SP's arguments that the *Compensation I* methodology

First: We determined that certain errors had been made in the calculation of the 5.47 earnings multiplier.[19] In the prior decision, a mixture of 1979 figures and "escalated" 1982 figures had been used in the calculation of the earnings multiplier; now, we determined that 1979 data should be used for the entire earnings multiplier analysis. In the prior decision, the earnings multiplier calculation had been based on the market value and earnings of the entire MPC (MPRR's corporate parent); now, we decided that the earnings multiplier should be based on railroad-only value and earnings; a figure supplied by UP was accepted as the best evidence of record for the market value of the railroad, but the parties were invited to present further evidence on this issue in support of a more accurate market valuation. Based on the data then available, we calculated a 7.74 earnings multiplier. Although the parties had not made an issue of the multiplier being based on a valuation derived from both road property and equipment property, we noted that the use of a multiplier based on both road and equipment overstated the value of the railroad property to be used in the trackage rights operations. Accordingly, we asked the parties to submit further data to determine an earnings multiplier based only on road property. *Compensation II, supra,* at 677-681.[20]

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impeded SP's ability to compete with UP. We explained, however, that the particular arguments advanced by SP represented a misunderstanding of the mechanical workings of the capitalized earnings methodology. *Compensation II, supra,* at 671-672.

[19] The terms *earnings multiple* and *earnings multiplier* have been used interchangeably.

[20] Although we were tinkering with the details of the earnings multiplier calculations, we adhered to the view previously expressed that the capitalized earnings approach was the most appropriate technique for valuing railroad assets in this proceeding. "The capitalized earnings approach estimates the value of the lines on the basis of a contemporaneous arms-length transaction, thereby reasonably approximating the fair market value. The going concern value of a corporation has been found to be an appropriate method of valuation. [Citations omitted.]

Second: In the prior decision, we had rules that the investment base (*i.e.*, the value of the Kansas City-St. Louis lines) was to be determined by multiplying the 1979 earnings of these lines by the earnings multiplier. Now, we ruled that the 1979 earnings of these lines was $18,287,939. The parties, however, were invited to submit further evidence regarding one aspect of the calculations involved in the development of this figure. *Compensation II, supra,* at 684-685.

Third: In the prior decision, the total return on the Kansas City-St. Louis lines had been determined by multiplying the investment base by MPRR's 10.21% 1979 pre-tax rate of return on investment (which had been calculated using MPRR's effective tax rate, not the statutory tax rate). Now, we ruled that total return would be determined by multiplying the investment base by the pre-tax equivalent of the current cost of capital for the railroad industry (calculated on a nominal basis, using a statutory tax rate), as determined annually. We cited the statutory mandate of revenue adequacy in support: "Perpetuating, without valid reason, a return that is insufficient in the long run to allow for adequate reinvestment is not justified." *Compensation II, supra,* at 682. We took note of the economic rationale of the cost of capital calculation, which reflects the statutory revenue adequacy mandate:

> The cost of capital rate represents the average cost to any of the railroads for obtaining capital. Its use favors no carrier over another and places both the incumbent and tenant railroads on an identical footing regarding a required rate of return. It prevents 'railroad shopping' where a carrier with a low return on investment is an attractive trackage target. It ensures that the

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* * *. We do not agree with the argument [advanced by SP] that the capitalized earnings approach grossly overstates the value of the Kansas City to St. Louis line segment." *Compensation II, supra,* at 674.

> renting carrier is not subsidized by the owning road. Moreover, the pre-tax equivalent of the industry cost of capital is used in abandonment proceedings and rate prescription proceedings in the absence of justification for some other figure. Such justification is not present on this record. [Citation omitted.]

Compensation II, supra, at 682-683.

We also noted SP's argument that every existing voluntary trackage rights agreement imposed an interest rate that was much less than the then applicable current cost of capital rate. *Compensation II, supra,* at 681. That might be true, we intimated, but those trackage rights agreements had been:

> freely entered into by two parties who are in agreement * * *. Furthermore, trackage rights agreements are usually reciprocal in nature, with each railroad granting the other trackage rights over their lines. In the instant proceeding, we are faced with adversary parties who are entering into trackage rights agreements not because of a mutual agreement, but as the result of the Commission's order in a consolidation proceeding. The Commission is being asked to set trackage rights compensation due to the inability of the parties to achieve a meeting of the minds. *Compensation II, supra,* at 682, n. 13.[21]

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[21] In *Compensation II,* in imposing the higher cost of capital rate in lieu of the lower return on investment rate, we acknowledged the *UP/MP/WP* statement that "a rate of return based on current cost of capital may not be reasonable." *Compensation II, supra,* at 688, and we noted the continuing importance of the *UP/MP/WP* principle that "any terms so onerous to the tenant as to defeat the purpose of the trackage rights cannot be considered just and reasonable." *Compensation II, supra,* at 669, 687-688. We explained our departure from the anti-cost of capital statement, and we attempted to reconcile the not-too-onerous principle with the cost of capital result:

Fourth: In *Compensation I*, we had ruled that interest rental owed by SP to UP would be determined by multiplying the total return on the Kansas City-St. Louis lines by SP's usage share. The precise details regarding the calculation of SP's usage share, however, had not been laid out. In *Compensation II*, we ruled that "usage should be based on a three-year moving average to avoid extreme fluctuations in rental based on sharp increases or decreases in usage. Ideally, the usage percentage should be determined by the railroads themselves, preferably using gross-ton-miles. [Footnote omitted.]" *Compensation II, supra*, at 687.

COMPENSATION III

In *Compensation III*, we affirmed the capitalized earnings methodology of the two prior decisions. With certain modifications now provided for, the final details of the four-part formula were in place.

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not-too-onerous principle with the cost of capital result:

> Upon reconsideration we have determined that we must use current cost of capital in order to determine reasonable compensation for the trackage rights granted in our prior decision. We have approached this finding trying to balance two interests: needed competition in the central corridor promoted by just and reasonable compensation terms; and rational compensation to the owning road.
>
> We believe our revisions to the formula reconcile these goals, and we find the compensation terms just and reasonable. We have tried to approximate the allocated value of these lines. Our refinements to the formula concerning use of 1979 data; bridge traffic; moving usage factor; market value of the MP; and roadway valuation are designed to place the renter in a similar position as the owner. By placing the renter in the same position as the owner, we believe we have achieved our goal of assuring a competitive relationship between the two systems on the line.

First: The earnings multiplier, which had been calculated as 7.74 based on a valuation derived from both road property and equipment property, was recalculated as 3.40 based on a valuation derived from road property only.[22]

Second: The 1979 earnings of the Kansas City-St. Louis lines, previously calculated as $18,287,939, were recalculated as $18,258,186. The investment base, *i.e.*, the value of the Kansas City-St. Louis lines, was therefore calculated as $62,077,832.40. *Compensation III, supra,* at 534.[23]

Third: We reiterated our holding in *Compensation II* that the total return on the investment base would be determined by multiplying the investment base by the pretax equivalent of the current cost of capital for the railroad industry (calculated on a nominal basis, using a statutory tax rate), as determined annually.

> A return on current market value, at a current nominal cost of capital rate, reflects the relevant economic costs for future movements involving access. Although specific identification and valuation of line segment assets may have been preferable to those developed on the record, we believe the interest rental result determined here is a practical approximation of the capital costs necessary to encourage UP to continue providing such assets. Furthermore, use of the industry-average current cost of capital rate is a practical alternative to the development of an individual

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[22] This 3.40 earnings multiplier does not actually appear in the text of the *Compensation III* decision. The decision itself calculates a 0.439 roadway multiplier. *Compensation III, supra,* at 533. The previously determined 7.74 earnings multiplier must then be multiplied by the 0.439 roadway multiplier; the product is the new 3.40 earnings multiplier.

[23] The $62,077,832.40 investment base calculation does not appear in the text of the *Compensation III* decision. This figure can be derived, however, by multiplying the recalculated 1979 earnings ($18,258,186) by the recalculated earnings multiplier (3.40).

> railroad rate, absent sufficient data to do so. [Footnote omitted.] In summary, we believe the use of the capitalized earnings approach (as modified here) represents a practical and reasonable measure of the specific assets required, or consumed, as a result of access. Sharing such identified costs between landlord (UP) and tenant (SP) on the basis of percentage usage places the parties on identical and competitive footing and ensures continued joint provision of service and adequate reinvestment.

Compensation III, supra, at 530. In affirming our adherence to the cost of capital approach, we rejected each of the four basic arguments advanced by SP in favor of the actual return approach. *Compensation III, supra,* at 534-539.

(a) SP argued that a cost of capital calculation was inappropriate because, in requiring SP to pay UP more than UP charges its own shippers for traffic moving on the line, a cost of capital calculation upsets the principle of competitive equality upon which approval of the UP/MP/WP merger was based. We rejected this argument:

> Contrary to SP's assumption, using cost of capital does not defeat the purpose of the trackage rights granted as a condition to the merger. SP receives enormous quantitative and qualitative benefits as a result of this trackage rights grant. SP has long sought direct access between Kansas City and St. Louis to cut approximately 400 miles off the length of its transcontinental route between the West Coast and St. Louis. [Citations omitted.] This grant should allow SP to realize substantial operational savings on West Coast-St. Louis shipments. SP also gains strategically since its position as a transcontinental carrier is enhanced. As we stated in *Compensation I,* "SP, with these trackage rights, has a greater ability

> to attract traffic to its lines, either for single-line SP movements between the St. Louis gateway and the West Coast or in conjunction with DRGW in the central corridor." [Citation omitted].

Compensation III, supra, at 536.

(b) SP argued that changing the "economic logic" from the "holding" in the *UP/MP/WP* decision would be arbitrary and capricious. We rejected this argument, pointing out that the *UP/MP/WP* decision did not hold that interest rental (i) could not be based on current cost of capital and (ii) had to be based on the actual rate of return.[24] We acknowledged that *Compensation I* had adopted the actual rate of return as part of the compensation formula, but we pointed out that the *Compensation II* decision had "outlined quite clearly our reasons for implementing a cost of capital approach." *Compensation III, supra,* at 538.

(c) SP argued that using a floating rate of return as an alternative would not lock UP into an inadequate return. We rejected this argument:

> This solution does not address the fundamental problem of cross-subsidization in the event that UP is not revenue adequate. It also does not consider the basic principle involved: where the rate of return is less than the cost of capital, the landlord derives insufficient revenue from the line to reinvest adequately in its maintenance and operation.

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[24] The precise language of the *UP/MP/WP* decision was: "With respect to existing rail properties, absent new capital investment relating to the trackage rights operations, a rate of return based on current cost of capital or opportunity cost *may not be reasonable* * * *. [T]he landlord's actual rate of return on the value of its rail properties *should be given consideration* in determining a just and reasonable rate of return." *UP/MP/WP, supra,* at 589-590 (underlining added).

Compensation III, supra, at 538.

We also pointed out that the rate of return approach could produce, at least in certain circumstances, absurd results. "For example, should the UP experience losses on a system basis, under SP's argument no rental charge [for the interest rental component] would be required at all." *Compensation III, supra,* at 536, n. 19.

(d) SP argued that, if cost of capital were used, SP must be allowed to submit additional evidence concerning the effects of such use on line competition. SP declared that, unless the proceeding was reopened for this purpose, it would not have had a sufficient opportunity to be heard on this issue. We rejected this argument:

> We see no contradiction between the establishment of an adequate evidentiary record and our actions in this case [Footnote omitted.] This proceeding has continued for six years. The interest rental issue has been extensively addressed by numerous parties. Both SP and UP have had ample opportunity to promote their respective positions on the relative merits of a rate-of-return versus a cost-of-capital approach. It is clearly within our prerogative to refrain from reopening a proceeding. [Citations omitted.] Therefore, we decline SP's request to reopen this proceeding on the interest rental issue.

Compensation III, supra, at 539.

To this end, we would only add that SP has never demonstrated the relevance of the evidence it seeks to adduce—the effect of our decision upon its ability or willingness to operate the trackage rights—to our determination that the formula we have adopted provides a reasonable and equitable basis of compensation for the trackage rights we have mandated.

Fourth: We affirmed, *sub silentio*, that SP's usage share should be based on a three-year moving average. This matter was not actually discussed in the text of the *Compensation III* decision.

THE PRIOR DECISIONS: A SUMMARY

Three main features stand out in the three *Compensation* decisions. First, interest rental (in essence, opportunity costs) should be determined by multiplying an investment base (in this case, the value of the Kansas City-St. Louis lines) by an interest rate.[25] Second, the investment base (*i.e.*, the value of the Kansas City-St. Louis lines) should be determined by the capitalized earnings methodology. Third, the interest rate by which the investment base should be multiplied should be the cost of capital rate.[26]

The earnings of the Kansas City-St. Louis lines were multiplied by the earnings multiplier to determine the investment base. The rationale for using the capitalized earnings methodology for determining the investment base was given in *Compensation I* and *Compensation II*. In large measure, the rationale turns upon the consideration that this methodology is predicated on the landlord carrier's continuing as a going concern. Neither party is entirely satisfied with the use of this methodology. SP would prefer to use a book value approach; UP would prefer to use an

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[25] Although this has been referred to loosely as the capitalized earnings methodology, that reference is misleading. "Capitalized earnings" refers only to the procedure for calculation of the investment base. No really descriptive name has been suggested for the idea that interest rental should be determined by multiplying an investment base by an interest rate.

[26] This is the pre-tax equivalent of the current cost of capital for the railroad industry (calculated on a nominal basis, using a statutory tax rate), as determined annually.

approach that approximates the Stand Alone Cost (SAC) Constraint of the *Coal Rate Guidelines*.[27]

The economic rationale for using cost of capital was given in *Compensation II* and *Compensation III*. In large measure, the rationale turns upon considerations of providing a sufficient incentive to the landlord carrier to maintain the route in first class operating condition. SP advanced several arguments against cost of capital; these arguments were considered at great length, and were rejected. *See Compensation III, supra*, at 534-539.[28] SP argued, *inter alia*, that a cost of capital calculation would require SP to pay UP more than UP charged its own shippers for traffic moving on the line, and therefore would upset the principle of competitive equality upon which approval of the UP/MP/WP merger had been based. We rejected this argument. *Compensation III, supra*, at 534-537.

On two occasions in 1990, we expressed our continuing adherence to the interest rental methodology adopted in

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[27] *See Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542-546 (1985), *aff'd Consolidated Rail Corp. v. U.S.*, 812 F.2d 1444 (3rd Cir. 1987). Because the Replacement Cost New Less Depreciation (RCNLD) approach urged by UP approximates the SAC constraint of the *Coal Rate Guidelines*, the investment base generated by the RCNLD approach will almost always be higher than the investment base generated by the capitalized earnings methodology.

[28] The cost of capital approach was not our original approach in this proceeding. In *Compensation II*, we explained in full our departure from our tentative remarks in the *UP/MP/WP* decision and from the rate of return analysis of *Compensation I*. In *Compensation III*, we specifically considered and rejected an SP argument that "changing" the "holding" in the *UP/MP/WP* decision would be arbitrary and capricious. *Compensation III, supra*, at 534 and at 537-538. And, also in *Compensation III*, we considered and rejected SP's apparent argument that "the Court of Appeals [in *Southern Pacific Transp. Co. v. I.C.C.*, 736 F.2d 708 (D.C. Cir. 1984)] was willing to uphold the consolidation decision without knowing the terms of trackage rights compensation only if the Commission adopted the rate of return formula * * *. We see no reason to accept [SP's] narrow reading of the court's decision." *Compensation III, supra*, at 538.

the *Compensation* decisions. *See Arkansas & Missouri R. Co. v. Missouri Pacific R. Co.*, 6 I.C.C.2d 619 (1990) (*A&M I*), 7 I.C.C.2d 164 (1990) (*A&M II*), *app. pending in abeyance sub nom. Missouri Pac. R.R. Co. v. ICC*, No. 91-1046 (D.C. Cir.).[29]

THE PETITION FOR CLARIFICATION

The issues with respect to which the parties seek clarification are narrow. The basic formula for calculating the interest rental component of trackage rights compensation has been established in the prior decisions. We need merely decide the four specific issues that the parties have raised regarding the application of that formula. Neither party has sought administrative reconsideration of *Compensation*

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[29] In the two *A&M* decisions, we endorsed the basic framework of the interest rental methodology, the idea that interest rental should be determined by multiplying an investment base by an interest rate. *See, e.g., A&M I, supra,* at 622: "We continue to believe that our *SSW Compensation* methodology, modified where necessary, provides the proper framework for a compensation analysis. [Footnote omitted.]"

In the two *A&M* decisions, we also endorsed the capitalized earnings methodology for the determination of the investment base. For various technical reasons peculiar to the *A&M* fact situation, however, we further held that the capitalized earnings approach, although preferable, could not actually be used in the *A&M* cases. We used, in lieu thereof, the Replacement Cost New Less Depreciation (RCNLD) approach that had been advocated by UP in the *Compensation* cases. *A&M I, supra,* at 623-628; *A&M II, supra,* at 169-170.

In the two *A&M* decisions, we reiterated that total return on investment should be determined by multiplying the investment base by the pre-tax cost of capital rate. *A&M I, supra,* at 628-629; *A&M II, supra,* at 171.

The overall result of the two *A&M* decisions was an affirmation of the continuing vitality of the interest rental methodology adopted in the *Compensation* decisions. The one important variation introduced in the *A&M* cases—the use of the RCNLD approach in the determination of the investment base—was necessitated by the peculiar *A&M* fact situation, and did not represent a departure from that aspect of the *Compensation* methodology.

III, and the normal 20-day time period for seeking such has long since expired.

(1) *Cost of Capital and Cost of Debt.* The first issue with respect to which the parties seek clarification is whether, for any particular month, calculations involving cost of capital and cost of debt should use (a) the latest available figures (*i.e.*, the most recent figures then available), or (b) the figures applicable to that month, but not available until some time after the end of that year.

An example may be useful. In January 1987, the latest available cost of capital figure (*i.e.*, the most recent figure then available) was the cost of capital for 1984 (25.52%). The applicable figure, *i.e.*, the cost of capital for 1987 (17.39%), would not be known until some time in 1988. The basic formula for the interest rental calculation for any month is: the computed valuation base (x) cost of capital (x) 1/12 (x) SP's monthly usage percentage. The amount of interest rental owed by SP for January 1987 will be substantially higher if the calculation uses the latest available cost of capital figure (25.52%), and it will be substantially lower if the calculation uses the cost of capital figure applicable to 1987 (17.39%).[30]

During most of the first 7 years of SP's trackage rights operations, *i.e.*, for 82 of the 84 months beginning with

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[30] In connection with our example, two disclosures should be made. (1) We have selected January 1987 for our example because, in the first 2.5 months of 1987, the discrepancy was greater than it had ever been before and than it has ever been since. (2) Our example looks at the discrepancy in terms of the cost of capital figure. The same basic discrepancy, but with different numbers, exists with the cost of debt figure, which is utilized to compute interest owed by SP. In January 1987, the latest available cost of debt figure was the cost of debt for 1984 (12.80%). The applicable figure, *i.e.*, the cost of debt for 1987 (9.30%), would not be known until some time in 1988. The amount of interest owed by SP for January 1987 will be substantially higher if the calculation uses the latest available cost of debt figure (12.80%), and it will be substantially lower if the calculation uses the cost of debt figure applicable to 1987 (9.30%).

January 1983 and ending with December 1989, (a) the latest available cost of capital figure was higher, and often substantially higher, than the applicable cost of capital figure, and (b) the latest available cost of debt figure was higher, and often substantially higher, than the applicable cost of debt figure.[31]

UP, seeking to maximize trackage rights compensation for the 1983-1989 period, argues that all pertinent calculations should use the latest available figures, determined as of the last day of the pertinent month. Use of the latest available figures, UP argues, allows the parties to know the amount of trackage rights compensation when usage occurs rather than many months later. Conceding that the latest available figures approach favors itself for the 1983-1989 period, UP suggests that such past advantage will be balanced by future disadvantage as the ongoing business cycle pushes interest rates up.[32]

SP, seeking to minimize trackage rights compensation for the 1983-1989 period, argues that all pertinent calculations should use the applicable figures, not the latest available ones. The latest available figures, SP points out, are necessarily out-of-date figures; they should not be applied to current operations. To make the cost of capital for one year serve as the cost of capital for another year would be, in SP's view, arbitrary and capricious.

UP also argues that the use of the latest available figures minimizes administrative burdens. Use of the applicable figures, UP warns, will necessarily entail complex retroactive adjustments. UP contends that SP's approach

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[31] In Appendix A to this decision, *infra*, we have presented the discrepancies between the latest available cost of capital figures and the applicable cost of capital figures for 1983-1991.

[32] As interest rates rise across the board over a lengthy period, the latest available cost of capital/debt figures will tend to be less than the applicable cost of capital/debt figures.

can only be utilized if SP's payments are first made on an interim basis using the latest available figures, and are then later adjusted, with interest, to take account of the applicable figures. SP concedes that retroactive adjustment will be necessary, but, pointing out that both parties have computerized the bill calculation process, it contends that the administrative burden of retroactive adjustment is a minor one. SP, however, disputes UP's assertion that interim payments would necessarily have to be based on the latest available figures; a negotiated rate, in SP's view, ought to suffice.

Each party cites to things said in the *Compensation* decisions in support of its argument that the *Compensation* decisions require the use of either the latest available figures approach (UP's preference) or the applicable figures approach (SP's preference). A fair reading of those decisions, however, suggests that we have not heretofore focused upon this particular issue.[33]

We are of the opinion that UP is entitled to the cost of capital rate applicable to a particular year, not the cost of capital rate for a prior year. The rate applicable to a particular year is the actual rate for that year; the rate applicable to a prior year is simply not, except by chance, the actual rate of return for the present year. To require

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[33] For example, UP notes that, in *Compensation II, supra,* at 691, we included, in a chart listing the cost of capital and cost of debt rates to be applied for various years, the rates for 1982. UP contends that, since we then knew that SP's trackage rights operations had not commenced in 1982, the only possible reason for the inclusion of the 1982 rates was because they were to be used to calculate SP's interest rental payments in subsequent years. This, UP contends, supports its argument for the use of the latest available figures. And indeed, at first glance, this does. As SP notes, however, at the time of *Compensation II,* we must also have known that, when SP's trackage rights operations commenced in January 1983, the then latest available figures were the 1981 figures, which are not included in the chart. This, of course, cuts against UP's latest available figures approach.

SP to pay interest rentals at a rate that is significantly higher than the actual rate for a particular year, which is what UP's latest available figures approach would require for almost the entire 1983-1989 period, would produce a windfall profit for UP.

We therefore clarify that the prior decisions require the use of the applicable cost of capital/debt figures, not the latest available such figures.

We recognize that the necessity for keeping payments current requires the establishment of an interim payments procedure. We therefore direct that the following procedure be adhered to by the parties. Interim interest rental payments, calculated by use of the latest available figures, should be made on a monthly basis. Thereafter, once the applicable figures have been announced, there will be an adjustment to the interim payments. If the interim payment has been low, the amount of the underpayment, plus interest thereon, will be paid by the end of the first month following the month in which the applicable figures have been announced. If the interim payment has been high, the amount of the overpayment, together with interest thereon, will be deducted from the interest rental payment otherwise due during the first month following the month in which the applicable figures have been announced. If the overpayment exceeds the interest rental payment otherwise due during the first such month, the interest rental payment(s) for subsequent month(s) will be similarly reduced.[34]

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[34] There is no particular reason to use, in the interim payments procedure, the latest available figures as opposed to negotiated figures. Nor is there any particular reason to require refunds to be achieved by withholding. These are essentially details which could reasonably be resolved in more ways than one. We would not object if the parties were to negotiate an interim payments procedure of their own.

We are not certain when payments will first be due under the interim payments procedure we have established. UP and SP are presently

(2) *Simple or Compound Interest.* The second issue with respect to which the parties seek clarification is whether the interest on SP's arrearages is compound interest or simple interest.

In order to make UP "whole," the prior decisions require SP to pay interest on its past due payments "at a rate equal to the railroad industry's then current cost of debt."[35] But the decisions are silent as to whether such interest is compound interest or simple interest.

By and large, our past practice has not favored compound interest. The most recent case on the subject, cited by both parties, is No. 37017, *Farmers Export Company v. The Atchison, Topeka and Santa Fe Railway Company, et al.* (not printed), served July 29, 1986 (*Farmers Export Company*). In that case, reparations, in the nature of refunds, were awarded to an export grain shipper in connection with certain demurrage charges. Interest on the reparations was also awarded. The shipper thereafter requested that the interest be compounded, and we denied this request, saying, at page 7:

> Finally, we also will deny FEC's request for compounding of interest. The interest provisions of the Interstate Commerce Act [49 U.S.C. § 10707], our policy statement, and our regulations do not require compounding of interest. Generally, the law does not favor this, and, in the absence of

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operating under what is called the Term Sheet agreement of January 6, 1983, which establishes an Interim Period in which interest rental payments are not being made on a current basis. (It should be noted that the word "interim" is being used in two quite different contexts.) A 1985 agreement has provided for some current payments, but these appear to be much smaller than the payments called for by the *Compensation* decisions. SP is apparently contending that the Interim Period will run until the termination of the judicial review process. If this is a correct reading of the situation, the interim payments procedure we have established may not become operational for some time to come.

[35] *Compensation I, supra,* at 792.

> a contract or statute providing for it, compound interest will not be allowed. [Citations omitted.] Our practice conforms to the general rule to deny compound interest. [Citations omitted.]

SP cites *Farmers Export Company* in support of its argument that interest should not be compounded. UP, attempting to distinguish *Farmers Export Company*, observes that payment of interest in refund and reparations cases is required by an express statutory provision, 49 U.S.C. § 10707, that does not call for compounding. UP also cites one Commission case that sanctioned the use of compound interest: *Railroad Cost Recovery Procedures*, 1 I.C.C.2d 207, 213 (1985) (*held*, the 3-month Treasury Bill rate, used on a compounded basis, "is the proper rate to use in the computation of opportunity costs").

SP's argument in favor of simple interest is essentially a legal one, premised heavily on the *Farmers Export Company* line of cases. SP buttresses its argument with the observation that, had we indeed intended that interest be compounded, we were remiss in neglecting to specify the frequency with which compounding was to occur.

UP's argument in favor of compound interest (compounded monthly) is essentially an economic one. The railroad cost of debt, UP contends, is an interest rate that is itself derived on a compound basis; therefore, this interest rate must be applied with compounding; if this interest rate is not compounded, UP's rate of return on SP's trackage rights payments will amount to less than the railroad cost of debt. Compounding of interest on SP's arrearages is required, UP argues, by the objective behind the award of interest: to make UP whole. Without compounding, UP contends, UP has been forced to make what is in effect an interest-free loan to SP in the amount of the unpaid interest that has accrued over the past 7.5 years.[36]

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[36] As a mechanical matter, UP's calculations work this way: for any

Farmers Export Company, and other cases with similar holdings, are not applicable in the present context. Such cases hold that a reference to "interest" in a statute, in a regulation, or in a policy statement, is generally to be read as a reference to "simple interest." In addition, those cases involve interest to be paid on reparations we have ordered, whereas in the present context, we deal with trackage rights compensation. There is no statutory reference to interest in this context. No statute calls for interest, or explains how interest is to be calculated, in connection with trackage rights compensation. The policy statement and regulation referenced in *Farmers Export Company* are similarly inapplicable in this context. *See Revised Procedures To Calculate Interest Rates*, 42 Fed. Reg. 20,701 (1977) (the policy statement) and 49 CFR § 1141.1, *Procedures to calculate interest rates* (the regulation). The question whether simple interest or compound interest ought to be applied in connection with arrearages accruing on past due trackage rights compensation payments is one we have never heretofore considered.[37]

Compound interest should be applied to SP's arrearages. Compound interest is required to make creditors whole.

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month, the month-end interest accrual is calculated by multiplying the beginning of the month debt balance by the annual interest rate (*i.e.*, cost of debt), and then dividing the product by 12. In effect, UP would compound monthly by dividing the annual interest by 12.

[37] In No. 37668S, *Huron Valley Steel Company v. Norfolk and Western Railway Company, et al.* (not printed), served April 15, 1985, we stated, at page 5, in rejecting a complainant's request for compound interest: "Unlike the FMC's [Federal Maritime Commission's] rule and the act of Congress governing money judgments in Federal courts, there is no comparable rule or statute requiring that interest be compounded in Commission refund decisions. Past Commission decisions have not permitted interest to be compounded. Thus, until Congress or this Commission acts to change current practices, the interest owed need not be compounded." In the present context, there is no current practice. No rule or statute speaks to the calculation of interest in connection with past due trackage rights compensation payments.

Interest earns interest. This implies compounding to compensate the lender for the borrower's use of this interest prior to payment. The use of simple interest would be equivalent to requiring the lender (UP) to make a *de facto* subsidy payment to the borrower (SP). We therefore require the use of compound interest in the calculation of SP's arrearages.

We further clarify that the prior decisions require that interest be compounded monthly, using a monthly rate equal to the 12th root of the annual rate. Due to compounding, UP's approach (wherein the monthly rate equals the annual rate divided by 12) would result in an effective annual rate in excess of the nominal annual rate.[38]

(3) *Calculating the Rolling Average.* The third issue with respect to which the parties seek clarification is how SP's usage should be calculated for the first 35 months of SP's trackage rights operations (January 1983 through November 1985).

The basic formula for the interest rental calculation for any month is: the computed valuation base (x) cost of capital (x) 1/12 (x) SP's monthly usage percentage. For purposes of this formula, however, SP's usage for any particular month is not SP's actual usage for that month. Instead, for purposes of this formula, SP's usage for any particular month is calculated on a 36-month rolling average basis.[39]

For December 1985 and all subsequent months, this 36-month rolling average is, for any such month, the average of SP's usage for the 36-month period ending with that month. On this, both parties agree.

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[38] In Appendix B to this decision, *infra*, we have presented a comparison of the two methods of compounding (UP's method, using a monthly rate equal to 1/12th of the annual rate, and the correct method, using a monthly rate equal to the 12th root of the annual rate).

[39] *See Compensation II, supra*, at 687 (discussed *supra*).

For the 35 months ending prior to December 1985, the prior decisions do not explain how the 36-month rolling average should be calculated.

UP contends that, for each of the first 35 months, SP's usage share should be based on a cumulative average of SP's usage shares for that month and all previous months beginning with January 1983. In effect, UP would phase in the 36-month rolling average over the first 36 months of SP's trackage rights operations. For January 1983, UP would use SP's actual usage share for that month; for February 1983, UP would use a 2-month average calculated over the first 2 months of SP's trackage rights operations; for March 1983, UP would use a 3-month average calculated over the first 3 months of SP's trackage rights operations; for November 1985, UP would use a 35-month average calculated over the first 35 months of SP's trackage rights operations; and for December 1985 and all subsequent months, UP would use a 36-month rolling average. This approach, in UP's view, implements the 36-month rolling average method to the maximum extent possible.

SP, rejecting UP's phase in approach, contends that the 36-month rolling average method should be applied, without any adjustment, to each month of its trackage rights operations. In effect, SP, in rejecting the phase in approach, would prefer to average in a good number of pre-1983 zeroes. For January 1983, by way of example, SP would calculate a 36-month average over the 36-month period beginning in February 1980. As a practical matter this approach averages in 35 months of zero use (February 1980 through December 1982) with 1 month of actual use (January 1983). SP's explanation for its approach is a literal one: because the prior decisions, in ordering a 36-month rolling average calculation, made no mention of any phase in adjustments, the 36-month rolling average calculation must be made without any such phase in adjustments.

As a practical matter, for the first 35 months of SP's trackage rights operations, the monthly interest rental payments generated by UP's phase in approach are substantially higher than the monthly interest rental payments generated by SP's approach. The discrepancy, of course, is greater in the first few months (starting with January 1983) and is smaller in the last few months (ending with November 1985).

Looking only at the 35-month phase in period (from January 1983 through November 1985), SP's approach would seem to be preposterous. Under SP's approach, it is not until December 1985 that SP is finally accruing interest rental obligations that have a close relationship to its actual usage of the Kansas City-St. Louis lines. For the first 35 months of SP's trackage rights operations, SP's approach would allow itself something of a free ride, a good deal more free in the opening months than in the later months, but free to some extent even as late as November 1985.[40]

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[40] Taking a broader perspective, and balancing the 35-month phase in period against a future 35-month phase out period, SP's approach may not be so self-serving. "[I]f SP's usage of the trackage rights were in the future to undergo a sustained decline, its average usage share would exceed its current usage share. SP would be paying for non-existent use for 36 [really 35] months. This discrepancy, which would arise in an exit scenario as SP's traffic shifts to other routes, would confer an advantage on UP that would not have been matched by any corresponding advantage to SP during the start-up period [assuming the use, during the first 35 months, of UP's phase in approach]. Particularly because of this feature of exit from the line, the Commission's order should be read according to its plain terms for the period of SP's entry onto the line." SP's reply filed September 4, 1990, at 36.

While there is some merit to SP's concern about establishing symmetry between the January 1983-December 1985 phase in period and a potential future phase out period, the problem need not and cannot be resolved now. We cannot now predict what SP's phase out will look like. The problem would be easy enough to resolve if SP's phase out were as drastic and clear cut as its phase in. The problem would not

SP's literal approach seriously understates SP's actual use of the lines during the phase in period, and therefore yields unrealistically low interest rental values during the phase in period. Accordingly, we reject SP's approach. UP's phase in approach, though it yields a more realistic assessment of SP's actual use of the lines during the phase in period, departs from the spirit of the 36-month rolling average calculation by basing its calculations on shorter time periods (1 month for January 1983; 2 months for February 1983; etc.). Accordingly, we also reject UP's phase in approach.

The correct application of the 36-month rolling average calculation during the first 35 months of SP's trackage rights operations ought to yield realistic interest rental values, and ought to be based on a 36-month calculation. We therefore clarify that the prior decisions require that, for the first 36 months of SP's trackage rights operations, SP's usage for any month should be calculated as the average of SP's usage for the entire 36-month period. In effect, this takes the 36-month rolling average calculated for December 1985, and projects that average back over each of the first 35 months. The advantage of this approach is that the average thus calculated is calculated over a full 36-month period, which is in keeping with the 36-month rolling average concept.[41]

(4) *Payment of Interest Rental on Improvements.* The fourth issue with respect to which the parties seek clarification is whether SP must pay interest rental on improvements made in the Kansas City-St. Louis lines between 1980 and 1982.

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be so easy to resolve if SP's phase out were a lingering one. If and when a phase out occurs, SP may petition for relief from any inequitable application of the 36-month rolling average calculation.

[41] As a practical matter, this approach produces total interest rentals somewhat lower than those produced by UP's approach, but much higher than those produced by SP's approach.

The basic formula for the interest rental calculation for any month is: the computed valuation base (x) cost of capital (x) 1/12 (x) SP's monthly usage percentage. As noted *supra*, the computed valuation base, reflecting the 1979 value of the road property, is $62,077,832.40. This 1979 valuation was based on the portion of the 1979 arms-length purchase price attributable to the Kansas City-St. Louis lines.

As thus expressed, this formula would seem to make no reference to improvements to the lines made after 1979. In the prior decisions, however, we established, with respect to improvements, a second valuation base, and granted SP an up front payment option with respect thereto:

> Accounting for the interest rental on improvements should be undertaken using a separate Improvements Valuation Base. This account should be generated using the actual cost of the new improvement multiplied by the actual UP cost of capital at the time the improvement is made and by SP's usage share. SP also must have the option to reimburse UP in advance for its share of the cost of new improvements rather than including the cost in a separate valuation base.

Compensation I, supra, at 802.

The parties seem to have divided all post-1979 improvements into two categories, those made in the 1980-1982 period, and those made after 1982.[42] For improvements

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[42] Two points should be noted. (1) Neither party has raised an issue as to when any particular improvement was made. There could be problems with respect to improvements "made" on or about either January 1, 1980, or January 6, 1983. (2) Both parties seem to regard January 1, 1983, and January 6, 1983, as a cut-off date. The cut-off date should be January 6, 1983, the date on which SP's trackage rights operations commenced.

made after 1982, SP concedes that it is required to pay for such improvements. It has elected, however, to pay for such improvements up front, and not in the form of interest rental.[43]

For improvements made in the 1980-1982 period, the parties disagree as to whether SP is required to pay for such improvements. SP, although conceding that it may be benefitting from some of the 1980-1982 improvements, contends that the compensation formula established in the prior decisions cannot reasonably be read to refer to such improvements, and that, for this reason, UP may properly seek payment for such improvements only upon a petition for reconsideration or modification of the prior decisions. SP notes that it had no right to use the lines during the first one to three years of the useful lives of the 1980-1982 improvements. Yet, if the 1980-1982 improvements go into the rate base, SP would have to pay the cost of capital on the full cost of such improvements without any reduction for depreciation. Because SP's trackage rights operations commenced in 1983, there would be an obvious problem even with an "up front" payment option for 1980-1982 improvements. There is no way that SP could make a truly up front payment. Furthermore, even if SP were given a so-called up front payment option, it would have to be assigned a usage share for such 1980-1982 improvements, and any such usage share would be inherently an arbitrary one.[44]

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[43] *See* SP's reply filed September 4, 1990, at 31, n. 25.

[44] In this connection, SP revives its pre-1983 zero-based usage share theory. Because the up front payment option would require SP to pay, with regard to any particular improvement, an amount equal to the cost of the improvement (x) SP's usage share, and because SP's usage share was zero at all times in the 1980-1982 period, any required up front payment would be, SP claims, zero. SP notes that UP would assign a higher usage share to SP for so-called up front payments with respect to 1980-1982 improvements (this higher percentage would apparently be calculated as the average of SP's usage over the first 36

UP contends that the prior decisions intended, although they did not specifically state, that all improvements made after the initial 1979 valuation of the lines were to be included in the Improvements Valuation Base. SP, UP argues, is not being asked to pay for usage in the 1980-1982 period, but only for post-1982 usage of all of the assets of the line, including those assets that were installed in the 1980-1982 period. UP contends that only if all improvements are included in the Improvements Valuation Base will SP be paying interest rental on the full value of the lines it is using.

The compensation formula should require SP to pay its fair share for its usage of the Kansas City-St. Louis lines; only by requiring it to do so will the competitive relationship between UP and SP be as contemplated by our guidelines. There is, for present purposes, no meaningful difference between the 1980-1982 improvements and the post-1982 improvements. Since the 1980-1982 improvements constitute a part of the assets being used by SP to its benefit, SP must pay its proportionate share for the 1980-1982 improvements. As with the post-1982 improvements, the prior decisions allow SP to pay for the 1980-1982 improvements via either the interest rental formula[45] or the up front payments option.[46]

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months of SP's trackage rights operations); but SP claims that this percentage, thus calculated, would be arbitrary. SP's reply filed September 4, 1990, at 34, n. 29.

[46] If, with respect to any particular improvement, SP selects the interest rental formula, its payment for any particular month would be determined thus: the improvements valuation base (x) cost of capital (x) 1/12 (x) SP's monthly usage percentage. We see no merit in SP's objection that, if the 1980-1982 improvements go into the rate base, SP will have to pay the cost of capital on the full cost of such improvements without any reduction for depreciation. The same would be true with regard to the assets included in the 1979 valuation of the lines; we have made no allowance for 1980-1982 depreciation on these assets. SP is not being required to pay for usage during the 1980-1982 period, but it is being required to pay for all assets used thereafter.

This decision will not significantly affect the quality of the human environment or the conservation of energy resources.

COMMISSIONER MCDONALD commenting:

I agree that the methodology developed in the *Compensation* decisions establishes reasonable terms for SP's use of the trackage rights. However, as I read *UP/MP/WP*, a primary focus there was on SP's *actual usage*, not a mere "competitive opportunity" to use these rights. The Commission concluded in the *UP/MP/WP* proceeding that certain specific trackage rights requested by SP[47] would offset the reduction in competition[48] for transcontinental traffic moving through the central corridor once the consolidation was approved. SP's trackage rights were viewed as "*a necessary part* of both central and southern corridor tran-

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whether these assets were part of the initial valuation base in 1979 or were added to the improvements valuation base in the 1980-1982 period. In any event, for any particular improvement, SP can simply avoid the interest rental formula altogether by selecting the up front payments option.

[46] If, with respect to any particular improvement, SP selects the up front payments option, its retroactive up front payment would be determined by multiplying the cost of the improvement times SP's applicable usage percentage. The prior decisions require that, for 1980-1982 improvements, SP's applicable usage percentage should be determined as the average of its first 3 years' usage (*i.e.*, for 1980-1982 improvements, SP's applicable usage percentage is the 36-month rolling average calculated for December 1985). A usage percentage thus determined, smoothing out monthly usage fluctuations over a substantial period, seems reasonable.

An up front payment for improvements made in the 1980-1982 period accrues interest. We clarify that the prior decisions require that, because the up front payment dates back to January 6, 1983, the interest accrual also dates back to January 6, 1983.

[47] Between Kansas City and St. Louis over the MP.

[48] The UP/MP/WP consolidation created a serious level of industry concentration in the Central Corridor submarket.

scontinental routing alternative to the new UP" (emphasis added). *UP/MP/WP*, 366 ICC at 587.

On appeal, the Court explicitly instructed the Commission "to ensure that the compensation terms will not defeat the purpose of the trackage rights".[49] However, SP should pay reasonable compensation to UP. Taken as a whole, I believe the compensation formula is reasonable and should not be so onerous as to defeat the purpose of the trackage rights.

COMMISSIONER SIMMONS, dissenting in part:

It is my opinion that the majority's analysis of the overall impact of the trackage rights compensation on Southern Pacific's ability to compete with the combined Union Pacific/Missouri Pacific system is based on an incomplete record. Therefore, it violates the mandate of the U.S. Court of Appeals as well as the Commission's own test enunciated in the 1982 decision approving the Union Pacific-Missouri Pacific merger. The Court of Appeals for the District of Columbia affirmed the consolidation because of the Commission's promise to undertake a complete analysis to determine whether any particular compensation terms would undermine SP's ability to compete. As I see it, the majority has not fulfilled this obligation, and I question whether, absent a more complete record, this decision has resolved the ultimate test that "the trackage rights tenant should operate over the involved line under economic conditions compatible to the landlord's," *Union Pacific-Control-Missouri Pacific, Western Pacific*, 366 I.C.C. 459,590 (1982) (*UP/MP/WP*).

Accordingly, I would have granted Southern Pacific's petition to reopen the record and instituted a separate proceeding to determine once and for all whether the trackage rights compensation terms may be so "onerous

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[49] *Southern P. Transp. Co. v. ICC*, 736 F.2d 708, 721 (D.C. Cir. 1984), *cert. den.*, 469 U.S. 1208 (1985).

to the tenant as to defeat the purpose of the trackage rights * * * ", *i.e.*, to provide viable competitive rail service to the Union Pacific/Missouri Pacific system. *Southern Pacific Transp. Co. v. ICC,* 736 F.2d 708, 721 (DC Cir. 1984). The thrust of SP's petition is that it has evidence to demonstrate that aspects of the current compensation terms do not comply with the court's directives. Because any such evidence would have a considerable bearing on any analysis or discussion of the competitive impact question, the proper course would have been to institute a separate proceeding to permit SP to introduce its evidence with appropriate reply by the Union Pacific. Only then can the Commission maintain that it has fulfilled its promise to the court to undertake this analysis. As the record now stands, I believe that the Commission cannot complete a thorough competitive analysis. Everything else is mere conjecture.

Moreover, a basic flaw in the majority's analysis is its tendency to insist that the Commission, by a grant of these trackage rights, is simply giving SP an opportunity to operate over these lines and if it cannot succeed under the present arrangements, so be it. This notion is inconsistent with the Commission's original intent in granting the trackage rights. In approving the consolidation, the Commission focused on the impact on the central corridor and concluded that the merger would reduce competition and harm the public. In response, this Commission determined that it was necessary to "provide an effective competitive alternative to the UP system in the central corridor." 366 I.C.C. at 547. We went on to clearly state that SP's trackage rights are "a necessary part of both central and southern corridor transcontinental routing alternatives to the new UP." 366 I.C.C. at 587. The grant was *not* designed to protect competitors, but to protect competition. If the trackage rights terms do indeed prove to be so onerous as to defeat the purpose of the trackage

rights, it would be the public that would suffer the loss of viable rail competition.

On the issue of whether the interest on SP's arrearage should be compound interest or simple interest, I would have insisted on simple interest, but permitted UP to introduce evidence to prove compound interest is justified in this instance. Under the present record, I see no reason to alter the Commission's longstanding policy of not awarding compound interest.

It is ordered:

1. The prior decisions in this proceeding are clarified as indicated in this decision.

2. The petition for clarification filed August 15, 1990, by Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company is granted only to the extent that the relief sought therein has been provided for in this decision. The petition is denied in all other respects.

3. This decision will be effective September 4, 1991.

By the Commission, Chairman Philbin, Vice Chairman Emmett, Commissioners Simmons, Phillips, and McDonald.

APPENDIX A

The discrepancies between the latest available cost of capital figures and the applicable cost of capital figures for 1983-1991 are listed in this chart:

Time Period	*Latest Available Figure*	*Applicable Figure*
1/1/83-8/4/83	25.81% (for 1981)	25.40% (for 1983)
8/5/83-12/31/83	28.28% (for 1982)	25.40% (for 1983)
1/1/84-10/31/84	28.28% (for 1982)	25.52% (for 1984)
11/1/84-12/31/84	25.40% (for 1983)	25.52% (for 1984)
1/1/85-12/31/85	25.40% (for 1983)	22.39% (for 1985)
1/1/86-1/6/86	25.40% (for 1983)	19.13% (for 1986)
1/7/86-12/31/86	25.52% (for 1984)	19.13% (for 1986)
1/1/87-3/16/87	25.52% (for 1984)	17.39% (for 1987)
3/17/87-8/21/87	22.39% (for 1985)	17.39% (for 1987)
8/22/87-12/31/87	19.13% (for 1986)	17.39% (for 1987)
1/1/88-6/6/88	19.13% (for 1986)	16.23% (for 1988)
6/7/88-12/31/88	17.39% (for 1987)	16.23% (for 1988)
1/1/89-5/3/89	17.39% (for 1987)	15.86% (for 1989)
5/4/89-12/31/89	16.23% (for 1988)	15.86% (for 1989)
1/1/90-7/12/90	16.23% (for 1988)	16.09% (for 1990)
7/13/90-12/31/90	15.86% (for 1989)	16.09% (for 1990)
1/1/91-6/20/91	15.86% (for 1989)	Not yet known (for 1991)
6/21/91-12/31/91	16.09% (for 1990)	Not yet known (for 1991)

The figures in this chart may be derived from our *Cost of Capital* releases for the past decade:

Docket Number	*Title*	*Citation*	*Service Date*
Ex Parte No. 415	Railroad Cost of Capital—1981	365 I.C.C. 734	6/24/82
Ex Parte No. 436	Railroad Cost of Capital—1982	367 I.C.C. 662	8/4/83
Ex Parte No. 452	Railroad Cost of Capital—1983	1 I.C.C.2d 643	10/31/84
Ex Parte No. 458	Railroad Cost of Capital—1984	1 I.C.C.2d 989	1/6/86
Ex Parte No. 464	Railroad Cost of Capital—1985	3 I.C.C.2d 625	3/16/87
Ex Parte No. 466	Railroad Cost of Capital—1986	3 I.C.C.2d 948	8/21/87
Ex Parte No. 473	Railroad Cost of Capital—1987	4 I.C.C.2d 621	6/6/88
Ex Parte No. 478	Railroad Cost of Capital—1988	5 I.C.C.2d 508	5/3/89
Ex Parte No. 486	Railroad Cost of Capital—1989	6 I.C.C.2d 836	7/12/90
Ex Parte No. 491	Railroad Cost of Capital—1990	7 I.C.C.2d 620	6/20/91

APPENDIX B

A comparison of the two methods of compounding (UP's method, using a monthly rate equal to 1/12th of the annual rate, and the correct method, using a monthly rate equal to the 12th root of the annual rate) reveals that (1) UP's method results in an effective annual rate in excess of the nominal annual rate, whereas (2) the correct method results in an effective annual rate equal to the nominal annual rate.

	1/12th of Annual Rate			*12th Root of Annual Rate*	
Year	Annual Current *Debt Cost*	Monthly *Debt Cost*	*Annual Compounding*	Monthly *Debt Cost*	Annual *Compounding*
1983	11.7000%	0.9750%	12.3483%	0.9263%	11.7000%
1984	12.8000%	1.0667%	13.5783%	1.0088%	12.7999%
1985	11.1000%	0.9250%	11.6825%	0.8810%	11.1000%
1986	8.9000%	0.7417%	9.2722%	0.7130%	8.9000%
1987	9.3000%	0.7750%	9.7068%	0.7438%	9.3000%
1988	9.7000%	0.8083%	10.1431%	0.7745%	9.7000%
1989	9.7000%	0.8083%	10.1431%	0.7745%	9.7000%
1990	9.8000%	0.8167%	10.2524%	0.7821%	9.8000%

ST. LOUIS SOUTHWESTERN RY. CO. COMPENSATION TRACKAGE RIGHTS

FINANCE DOCKET NO. 30000 (SUB-NO. 16)

ST. LOUIS SOUTHWESTERN RAILWAY COMPANY—TRACKAGE RIGHTS OVER MISSOURI PACIFIC RAILROAD COMPANY—KANSAS CITY TO ST. LOUIS

Decided November 13, 1991

In the first three decisions in this proceeding, the Commission established the basic framework for the calculation of the interest rental component of the trackage rights compensation owed to Union Pacific Railroad Company (UP) for the Kansas City-St. Louis trackage rights awarded to Southern Pacific Transportation Company (SP) in the 1982 *UP/MP/WP* case. In the fourth decision in this proceeding, the Commission clarified several technical issues not explicitly considered in the first three decisions. In the present decision, the Commission is denying a petition to reconsider and reopen various aspects of the prior decisions.

BY THE COMMISSION:

In 1982, we approved an application seeking authorization for the control of Missouri Pacific Railroad Company (MPRR) and Western Pacific Railroad Company (WPRR) by Union Pacific Corporation (UPC) and Union Pacific Railroad Company (UPRR). *Union Pacific—Control—Missouri Pacific; Western Pacific,* 366 I.C.C. 459 (1982) (*UP/MP/WP*).[1] Recognizing that such approval, if uncondi-

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[1] The surviving corporate entities (UPC, UPRR, and MPRR) are referred to collectively as UP.

tioned, threatened to eliminate existing intramodal rail competition in the Central Transcontinental Corridor, we conditioned our approval of the UP/MP/WP consolidation upon the grant of certain trackage rights to St. Louis Southwestern Railway Company (SSW), a subsidiary of Southern Pacific Transportation Company (SP).[2] In particular, we granted SSW trackage right over MPRR's lines between Kansas City and St. Louis. *UP/MP/WP, supra*, at 585-589.[3]

In 1983, after SP's trackage rights operations had begun, UP and SP, unable to reach a negotiated agreement on the "interest rental" component of trackage rights compensation, petitioned us to establish terms. In decisions served in 1984, 1988, and 1989, we established the basic framework for the calculation of the interest rental component of trackage rights compensation. *St. Louis Southwestern Ry. Co.-Trackage Rights Compensation*, 1 I.C.C.2d 776 (1984). 4 I.C.C.2d 668 (1988), and 5 I.C.C.2d 525 (1989) (*Compensation I, Compensation II,* and *Compensation III*, respectively).

The framework established in these three decisions provides for interest rental to be calculated by multiplying the valuation base by the pre-tax railroad cost of capital. The product of that calculation (which is, in effect, an

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[2] In general, SP and SSW are referred to collectively as SP.

[3] The *UP/MP/WP* decision was challenged on appellate review on various grounds. In particular. SP challenged our failure to fix the terms under which UP would be paid for the use of its track, and argued that because the level of compensation had not been fixed, it was impossible to tell whether SP's trackage rights operations would be competive with UP's operations. The challenge was rejected. *Southern Pacific Transp. Co. v. I.C.C.*, 736 F.2d 708. 721 (D.C.Cir.1984) (*Southern Pacific*) ("[W]e trust the Commission to ensure that the compensation terms will not defeat the purpose of the trackage rights. The ICC has in fact guaranteed that it will see to the proper functioning of the trackage rights." Citation omitted), *cert. denied.* 469 U.S. 1208 (1985).

annual interest rental figure applicable to both railroads using the lines) is divided by 12 to put it on a monthly basis. For any particular month, the figure last arrived at is multiplied by a percentage representing SP's usage of the lines for that month. Interest on unpaid amounts is calculated using the pre-tax railroad cost of debt.

In 1990, UP and SP sought clarification of several technical issues with regard to the calculation of the interest rental component of trackage rights compensation.[4] We clarified these issues in *St. Louis Southwestern Ry. Co.-Trackage Rights Compensation*, 8 I.C.C.2d 80 (1991) (*Compensation IV*). One of these technical issues was whether the interest on SP's arrearages is compound interest or simple interest. We clarified that the prior decisions required the use of compound interest in the calculation of SP's arrearages. *Compensation IV*, *supra*, at 101-104.[5]

On September 24, 1991, SP filed a petition to reconsider and reopen. SP seeks reopening of *Compensation II* and *Compensation III*, and reconsideration and reopening of *Compensation IV*.[6] SP's petition is directed to two specific aspects of these decisions: cost of capital and compound

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[4] Although UP filed the petition for clarification, it was clear that clarification was sought by both parties.

[5] *Compensation II* and *Compensation III* are on appeal in the United States Court of Appeals for the District of Columbia Circuit *sub nom. Union P. Corp. v. ICC.* Nos. 88-1186, 89-1443 and 89-1483 (D.C. Cir. filed March 8, 1988, July 20, 1989, and August 4, 1989). That consolidated appeal had been held in abeyance pending our decision in *Compensation IV*. We are authorized to rule on this permitted petition for reconsideration notwithstanding the pendency of the court proceeding. *United States v. Benmar Transp. & Leasing Corp.*, 111 U.S. 4 (1979) (pending judicial review proceeding does not divest agency of jurisdiction over underlying case), and accordingly we will do so. We will, of course, notify the court of this decision when it is served.

[6] *Compensation IV* is on appeal in the United States Court of Appeals for the District of Columbia Circuit *sub nom. Southern Pl. Transp. Co. v. ICC.* No. 91-1529 (D.C. Cir. filed on or about November 5, 1991).

interest. On October 15, 1991, UP filed its opposition to SP's petition. For the reasons expressed in this decision, we are denying the petition.[7]

DISCUSSION AND CONCLUSIONS

SP has failed to justify its request for reopening of *Compensation II* and *Compensation III*, and it has similarly failed to justify its request for reconsideration and reopening of *Compensation IV*. SP has not shown that our prior determinations respecting cost of capital and compound interest involve material error. Nor has it shown that our prior determinations respecting these matters would be affected materially because of new evidence or substantially changed circumstances.[8]

Cost of Capital. In our recent *Compensation IV* decision, we reviewed the development of the rule that the interest

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[7] SP has raised a question regarding the applicability of the 20-page limit prescribed in 49 C.F.R. § 1115.3(d). *See* SP's petition filed September 24, 1991, at 23, n.14. UP has not objected to the length of SP's pleading and we accept it.

[8] SP's petition implicates both 49 C.F.R. § 1115.4 (insofar as it is directed to administratively final actions taken in *Compensation II* and *Compensation III*). For present purposes, however, there is but one standard against which the petition must be judged.

By statute, an administratively final proceeding may be reopened, reconsideration of action taken therein may be granted, and that action may be changed upon a showing of material error, new evidence, or substantially changed circumstances. 49 U.S.C. § 10327(g)(1). By regulation, an interested party seeking reopening, reconsideration, and/or such a change must specify the material error sought to be corrected, the new evidence sought to be introduced, and/or the substantially changed circumstances sought to be demonstrated. 49 C.F.R. § 1115.4.

By regulation, a petition to reopen an action taken by the entire Commission in the first instance, filed within 20 days after the service of the action must show either that the prior action involves material error or that the prior action will be affected materially because of new evidence or changed circumstances. 49 C.F.R. § 1115.3.

rate by which the investment base should be multiplied should be the cost of capital rate, *i.e.*, the pre-tax equivalent of the current cost of capital for the railroad industry (calculated on a nominal basis, using a statutory tax rate), as determined annually. In *Compensation I*, we ruled that the total return on the Kansas City-St. Louis lines was to be determined by multiplying the investment base by MPRR's 10.21 percent 1979 pre-tax rate of return on investment (which had been calculated using MPRR's effective tax rate, not the statutory tax rate).[9] In *Compensation II*, however, we re-examined this methodology and held instead that the total return would be determined by multiplying the investment base by the pre-tax equivalent of the current cost of capital for the railroad industry (calculated on a nominal basis, using a statutory tax rate), as determined annually.[10] In *Compensation III*, we reiterated our cost of capital ruling and rejected each of the four basic arguments advanced by SP in favor of its "actual return" approach.[11]

In *Compensation IV*, we summarized the rationale for using cost of capital in the determination of the interest rental component of trackage rights compensation.

> The economic rationale for using cost of capital was given in *Compensation II* and *Compensation III*. In large measure, the rationale turns upon considerations of providing a sufficient incentive to the landlord carrier to maintain the route in first class operating condition. SP advanced several arguments against cost of capital: these arguments were considered at great length, and were rejected. *See Compensation III, supra.* at 534-539. SP argued, *inter alia.* that a cost of capital calculation would require SP to pay UP more

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[9] *Compensation IV, supra.* at 89.

[10] *Compensation IV, supra.* at 91-92.

[11] *Compensation IV, supra.* at 93-95.

> than UP charged its own shippers for traffic moving on the line and therefore would upset the principle of competitive equality upon which approval of the UP/MP/WP merger had been based. We rejected this argument *Compensation III, supra*, at 534-537.
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> *Compensation IV, supra.* at 96-97 (footnotes omitted).

SP, in its petition filed September 24, 1991, asks that the record be reopened to receive evidence on the competitive effects of using cost of capital. SP argues that using cost of capital defeats the pro-competitive purpose of the trackage rights grant, that using cost of capital violates an asserted commitment by this Commission to the U.S. Court of Appeals for the District of Columbia Circuit that upheld the *UP/MP/WP* decision, and that we have violated due process in not allowing SP to submit evidence regarding the competitive effects of using cost of capital. SP has submitted, with its petition, a verified statement of two economists with respect to the cost of capital issue. They argue that the purpose of competition preservation demands adherence to a "party principle" and conclude that the cost of capital approach violates that principle.[12]

None of this is new. All of these arguments have been made before, have been considered before, and have been rejected before. We have concluded that the cost of capital

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[12] The evidence that SP wants us to receive is not limited to the verified statement submitted with its petition. SP contemplates another round of evidentiary filings. Examples of the types of evidence that SP would seek to place before us would include: evidence with respect to the contribution earned by UP and SP on their competitive traffic: evidence with respect to the variable costs of UP and SP in carrying competitive traffic; evidence with respect to the service differences between the carriers on competitive traffic; evidence on the effects of a floating rate of return on UP's ability to earn adequate revenues; and evidence on whether the trackage rights compensation determined by the cost of capital formula would prevent SP from carrying traffic for which it is the efficient carrier.

approach does not defeat the pro-competitive purpose of the trackage rights grant.[13] We have concluded that the cost of capital approach does not violate any undertaking by the Commission in *UP/MP/WP* (as reiterated by the court in *Southern Pacific, supra*).[14] We have concluded that we do not violate SP's rights to due process by precluding it from submitting another round of evidence regarding the competitive effects of using cost of capital.[15] And the

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[13] *See Compensation IV, supra.* at 94, citing *Compensation III, supra.* at 536:

> Contrary to SP's assumption, using cost of capital does not defeat the purpose of the trackage rights granted as a condition to the merger. SP receives enormous quantitative and quantitative benefits as a result of this trackage rights grant. SP has long sought direct access between Kansas City and St. Louis to cut approximately 400 miles off the length of its transcontinental route between the West Coast and St. Louis. [Citations omitted.] This grant should allow SP to realize substantial operational savings on West Coast-St. Louis shipments. SP also gains strategically since its position as a transcontinental carrier is enhanced. As we stated in *Compensation I*, "SP, with these trackage rights, has a greater ability to attract traffic to its lines, either for single-line SP movements between the St. Louis gateway and the West Coast or in conjunction with DRGW in the central corridor." [Citation omitted].

[14] *See Compensation IV, supra.* at 97, n. 28, citing *Compensation III, supra,* at 538:

> [I]n *Compensation III*, we considered and rejected SP's apparent argument that "the Court of Appeals [in *Southern Pacific Transp. Co. v. I.C.*, 736 F.2d 708 (D.C. Cir. 1984)] was willing to uphold the consolidation decision without knowing the terms of trackage rights compensation only if the Commission adopted the rate of return formula * * * We see no reason to accept [SP's] narrow reading of the court's decision."

[15] *See Compensation IV, supra.* at 95, citing *Compensation III, supra.* at 539.:

> We see no contradiction between the establishment of an

so-called "party principle" is not new either. It is nothing more than another name for the "principle of competitive equality" mentioned *supra*.

SP has failed to demonstrate material error in our prior determinations respecting cost of capital. It has similarly failed to demonstrate that our prior determinations respecting cost of capital would be affected materially because of new evidence or substantially changed circumstances.[16]

Compound interest. In our recent *Compensation IV* decision, we considered whether the interest accruing on SP's arrearages should be computed on a compound or simple basis. Our prior decision had been silent on this point, and the matter appeared to be one of first impression. We concluded that compound interest was required:

> Compound interest should be applied to SP's arrearages. Compound interest is required to make creditors whole. Interest earns interest. This implies compounding to compensate the lender for the borrower's use of this interest prior

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adequate evidentiary record and our actions in this case. [Footnote omitted.] This proceeding has continued for 6 years. The interest rental issue has been extensively addressed by numerous parties. Both SP and UP have had ample opportunity to promote their respective positions on the relative merits of a rate-of-return versus a cost-of-capital approach. It is clearly within our prerogative to refrain from reopening a proceeding. [Citations omitted.] Therefore, we decline SP's request to reopen this proceeding on the interest rental issue.

[16] We will assume, *arguendo*, that the evidence that SP would propose to introduce on the cost of capital issue would be "new" evidence. But as we said in *Compensation IV, supra.* at 95. "To this end, we would only add that SP has never demonstrated the relevance of the evidence it seeks to adduct—the effect of our decision upon its ability or willingness to operate the trackage rights—to our determination that the formula we have adopted provides a resonable and equitable basis of compensation for the trackage rights we have mandated."

> to payment. The use of simple interest would be equivalent to requiring the lender (UP) to make a *de facto* subsidy payment to the borrower (SP). We therefore require the use of compound interest in the calculation of SP's arrearages.
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> *Compensation IV, supra.* at 103.

SP, in its petition filed September 24, 1991, asks that we either switch to simple interest (perhaps allowing UP an opportunity to introduce evidence in support of compound interest), or, at the very least, presume compound interest but reopen for evidence on the issue. SP advances two arguments in support of its request. First, it argues that we have failed to explain a departure from a longstanding policy of awarding only simple interest. Second, it argues that its troubled financial condition weighs in favor of simple interest. SP contends we were obliged to consider this matter in deciding whether to impose compound interest. SP states: "The Commission's opinion fails completely to recognize that in the circumstances of this case, the question of compound interest was not simply a matter of abstract economics but of real life impacts."[17] SP, in its alternative request for relief on the compound interest/simple interest issue (in asking that we reopen for evidence), does not specify what evidence it proposes to submit. But the context suggests that the evidence SP contemplates is evidence of its weak financial condition.

We cannot agree that our use of compound interest in this case represents a departure from a "longstanding policy" of awarding simple interest. We had never previously considered the issue. As we stated in *Compensation IV, supra*, at 103, n.37: "In the present context, there is no current practice. No rule or statute speaks to the calculation of interest in connection with past due trackage rights compensation payments."

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[17] SP's petition filed September 24, 1991, at 21.

In *Compensation IV, supra,* at 103, we noted that, in prior reparations, cases, we had held that "a reference to 'interest' in a statute, in a regulation, or in a policy statement, is generally to be read as a reference to 'simple interest.'" We explained, however, that no statute, no regulation, and no policy statement called for interest, or explained how interest was to be calculated, in the trackage rights compensation context. SP argues that we failed to distinguish the reparations cases from the present trackage rights compensation case. Why, it asks, is simple interest the rule in the reparations context, whereas compound interest is now to be the rule in the trackage rights compensation context? In awarding reparations we are bound by a long history of congressional enactments. In determing compensation for trackage rights, we write on a clean slate. The interest payment is intended to compensate UP for receiving its compensation later, rather than when the compensation was due. The compounding of interest is a universal financial practice and approximates UP's cost of forgoing the compensation payments much more closely than would simple interest.

As regards SP's second argument, even assuming *arguendo* that SP's financial condition is as "troubled" as SP intimates, we cannot agree that this factor weighs in favor of simple interest. However troubled SP's financial condition may be, SP has not explained why its present financial situation should have any bearing on what is necessary to make UP "whole" for the funds owed it by SP for as long as 9 years. As UP notes in its reply in opposition to SP's petition, there is no apparent reason why UP should be forced to provide SP a subsidy by lending it funds at a lower rate than UP's cost of capital.[18]

SP has failed to demonstrate material error in our prior determination respecting compound interest. It has similarly failed to demonstrate that our prior determination

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[18] UP's opposition filed October 15, 1991, at 13.

respecting compound interest would be affected materially because of new evidence or substantially changed circumstances.[19]

This decision will not significantly affect the quality of the human environment or the conservation of energy resources.

It is ordered:

1. The petition to reconsider and reopen filed September 24, 1991, by Southern Pacific Transportation Company and St. Louis Southwestern Railway Company is denied.

2. This decision will be effective December 2, 1991.

By the Commission, Chairman Philbin, Vice Chairman Emmett. Commissioners Simmons, Phillips, and McDonald. Commissioner Simmons would have granted the Petition for Reconsideration.

Sidney L. Strickland, Jr.
Secretary

(SEAL)

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[19] There is an issue not addressed by SP, as to whether evidence of SP's assertedly troubled financial condition is really "new evidence" in the conventional sense. If such evidence had been available on September 4, 1990 (the date of filing of SP's reply to UP's petition for clarification), then such evidence would not now be new evidence in the conventional sense of "newly available" or "newly discoverable." *See Omaha Public Power District v. BN R. Co.l,* 3 I.C.C.2d 853, 862 (1987) ("Evidence reasonably available to a party during the original proceeding is not new evidence."). A similar rule would apply to evidence of substantially changed circumstances: there would have to be a substantial change. In the present decision, however, we are not relying on this factor. Even if SP's evidence were new and even if its circumstances were substantially changed, this would be irrelevant to the compound interest determination.

§ 10101a. Rail transportation policy

In regulating the railroad industry, it is the policy of the United States Government—

(1) to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail;

(2) to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required;

(3) to promote a safe and efficient rail transportation system by allowing rail carriers to earn adequate revenues, as determined by the Interstate Commerce Commission;

(4) to ensure the development and continuation of a sound rail transportation system with effective competition among rail carriers and with other modes, to meet the needs of the public and the national defense;

(5) to foster sound economic conditions in transportation and to ensure effective competition and coordination between rail carriers and other modes;

(6) to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital;

(7) to reduce regulatory barriers to entry into and exit from the industry;

(8) to operate transportation facilities and equipment without detriment to the public health and safety;

(9) to cooperate with the States on transportation matters to assure that intrastate regulatory jurisdic-

tion is exercised in accordance with the standards established in this subtitle;

(10) to encourage honest and efficient management of railroads and, in particular, the elimination of noncompensatory rates for rail transportation;

(11) to require rail carriers, to the maximum extent practicable, to rely on individual rate increases, and to limit the use of increases of general applicability;

(12) to encourage fair wages and safe and suitable working conditions in the railroad industry;

(13) to prohibit predatory pricing and practices, to avoid undue concentrations of market power and to prohibit unlawful discrimination;

(14) to ensure the availability of accurate cost information in regulatory proceedings, while minimizing the burden on rail carriers of developing and maintaining the capability of providing such information; and

(15) to encourage and promote energy conservation.

(Added Pub.L. 96-448, Title I, § 101(a), Oct. 14, 1980, 94 Stat. 1897.)

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§ 10704. Authority and criteria: rates, classifications, rules, and practices prescribed by Interstate Commerce Commission

* * * * *

(a)(2) The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under that subchapter that are adequate, under honest, economical, and efficient management, to

cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business. The Commission shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph. However, a rate, classification, rule, or practice of a rail carrier may be maintained at a particular level to protect the traffic of another carrier or mode of transportation only if the Commission finds that the rate or classification, or rule or practice related to it, reduces or would reduce the going concern value of the carrier charging the rate. Revenue levels established under this paragraph should—

(A) provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and

(B) attract and retain capital in amounts adequate to provide a sound transportation system in the United States.

* * * * *

§ 10709. Determination of market dominance in rail carrier rate proceedings

(a) In this section, "market dominance" means an absence of effective competition from other carriers or modes of transportation for the transportation to which a rate applies.

* * * * *

§ 11341. Scope of authority

(a) The authority of the Interstate Commerce Commission under this subchapter is exclusive. A carrier or corporation participating in or resulting from a transaction

approved by or exempted by the Commission under this subchapter may carry out the transaction, own and operate property, and exercise control or franchises acquired through the transaction without the approval of a State authority. A carrier, corporation, or person participating in that approved or exempted transaction is exempt from the antitrust laws and from all other law, including State and municipal law, as necessary to let that person carry out the transaction, hold, maintain, and operate property, and exercise control or franchises acquired through the transaction. However, if a purchase and sale, a lease, or a corporate consolidation or merger is involved in the transaction, the carrier or corporation may carry out the transaction only with the assent of a majority, or the number required under applicable State law, of the votes of the holders of the capital stock of that corporation entitled to vote. The vote must occur at a regular meeting, or special meeting called for that purpose, of those stockholders and the notice of the meeting must indicate its purpose.

* * * * *

§ 11343. Consolidation, merger, and acquisition of control

(a) The following transactions involving carriers providing transportation subject to the jurisdiction of the Interstate Commerce Commission under subchapter I (except a pipeline carrier), II, or III of chapter 105 of this title may be carried out only with the approval and authorization of the Commission:

(1) consolidation or merger of the properties or franchises of at least 2 carriers into one corporation for the ownership, management, and operation of the previously separately owned properties.

(2) a purchase, lease, or contract to operate property of another carrier by any number of carriers.

(3) acquisition of control of a carrier by any number of carriers.

(4) acquisition of control of at least 2 carriers by a person that is not a carrier.

(5) acquisition of control of a carrier by a person that is not a carrier but that controls any number of carriers.

(6) acquisition by a rail carrier of trackage rights over, or joint ownership in or joint use of, a railroad line (and terminals incidental to it) owned or operated by another rail carrier.

* * * * *

§ 11344. Consolidation, merger, and acquisition of control: general procedure and conditions of approval

* * * * *

(b)(1) In a proceeding under this section which involves the merger or control of at least two class I railroads, as defined by the Commission, the Commission shall consider at least the following:

* * * * *

(E) whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region.

* * * * *

(c) The Commission shall approve and authorize a transaction under this section when it finds the transaction is consistent with the public interest. The Commission may impose conditions governing the transaction. When the transaction contemplates a guaranty or assumption of payment of dividends or of fixed charges or will result in an increase of total fixed charges, the Commission may ap-

prove and authorize the transaction only if it finds that the guaranty, assumption, or increase is consistent with the public interest. When a rail carrier, or a person controlled by or affiliated with a rail carrier, is an applicant and the transaction involves a motor carrier, the Commission may approve and authorize the transaction only if it finds that the transaction is consistent with the public interest, will enable the rail carrier to use motor carrier transportation to public advantage in its operations, and will not unreasonably restrain competition. When a rail carrier is involved in the transaction, the Commission may require inclusion of other rail carriers located in the area involved in the transaction if they apply for inclusion and the Commission finds their inclusion to be consistent with the public interest.

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SUPREME COURT, U.S.
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No. 92-1612

In the Supreme Court of the United States

OCTOBER TERM, 1992

SOUTHERN PACIFIC TRANSPORTATION COMPANY AND ST. LOUIS SOUTHWESTERN RAILWAY COMPANY, PETITIONERS

v.

INTERSTATE COMMERCE COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Whether the Interstate Commerce Commission abused its discretion in adopting a method for calculating how much a railroad granted trackage rights in an earlier consolidation proceeding should pay to the railroad that owned the track.

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BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is unpublished, but the decision is noted at 978 F.2d 745 (Table). The decisions of the Interstate Commerce Commission (Pet. App. 7a-199a) are reported at 1 I.C.C.2d 776, 4 I.C.C.2d 668, 5 I.C.C.2d 525, 8 I.C.C.2d 80, and 8 I.C.C.2d 213.

JURISDICTION

The judgment of the court of appeals (Pet. App. 1a) was entered on October 30, 1992. A petition for rehearing was denied on January 6, 1993. Pet. App. 4a.

The petition for a writ of certiorari was filed on April 6, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. More than ten years ago, the ICC approved, and the United States Court of Appeals for the District of Columbia Circuit affirmed, the consolidation of the Union Pacific Railroad Company, the Missouri Pacific Railroad Company (MP), and the Western Pacific Railroad Company (collectively, UP) in light of the substantial public benefits that would accrue from the transaction. *Union Pac. Corp. - Control - Missouri Pac.; Western Pac.*, 366 I.C.C. 462 (1982) (*UP Control*), aff'd *sub nom. Southern Pac. Transp. Co.* v. *ICC*, 736 F.2d 708 (D.C. Cir. 1984) (*Southern Pacific*), cert. denied, 469 U.S. 1208 (1985). The Commission determined that the potential anti-competitive effects of the consolidation could be allayed by granting the applications of several competing railroads for trackage rights to operate their trains over portions of the new consolidated system. *E.g.*, *UP Control*, 366 I.C.C. at 567, 578, 586. Of relevance here, petitioners were awarded trackage rights over MP's lines between Kansas City and St. Louis, Missouri. The object of the award was to permit the establishment of a new competitive route in the central transportation corridor between the West Coast and St. Louis.

The parties to the consolidation proceeding were unable to agree on compensation for the trackage rights during the pendency of the merger proceeding. Nonetheless, the Commission required that the grantees of trackage rights be permitted to com-

mence operations upon consummation of the consolidation. *UP Control*, 366 I.C.C. at 590. The Commission directed the parties to attempt to resolve the compensation disputes on their own (subject to the ICC's approval), or return to the agency if they were unable to do so. *Id.* at 589. As guidance to the parties, the Commission stated that "terms so onerous to the [grantees] as to defeat the purpose of the trackage rights cannot be considered just and reasonable." *Id.* at 590. On appeal, the District of Columbia Circuit rejected petitioners' claim that the ICC's refusal to set compensation terms for the trackage rights before such operations began undermined the Commission's decision. *Southern Pacific*, 736 F.2d at 721. The court observed that "[t]he ICC has in fact guaranteed that it will see to the proper functioning of the trackage rights." *Ibid.*

2. Of all the carriers awarded trackage rights over UP as a condition of approval of the consolidation, petitioners alone were unable to reach agreement with UP on the compensation to be paid and asked the Commission to fix the terms. In the proceedings below, the Commission devised a formula for calculating the monthly compensation to be paid by petitioners for the Kansas City-to-St. Louis trackage rights. Under that formula, petitioners were required to pay UP an amount reflecting (1) the costs caused by petitioners' operations over the line; (2) a usage-based proportional share of the overhead maintenance and operating costs and taxes; and (3) a usage-based proportional share of a "rental" based on the value of the line. See generally Pet. App. 155a-165a (describing methodology).

The major disputes in the compensation proceedings concerned the choice of an investment base, the measure of the rate of return, and petitioners' ability to provide the sort of competitive service envisioned by the Commission in imposing the trackage rights condition. Throughout the proceedings, the Commission remained cognizant of the underlying principle, stated in *UP Control*, 366 I.C.C. at 590, that it would assure that the terms of the trackage rights agreement would not be so onerous as to defeat its purpose. Pet. App. 12a, 93a, 136a-140a, 149a-151a, 164a, 194a-196a. As the Commission observed (Pet. App. 93a):

> We have approached this [methodology] trying to balance two interests: needed competition in the central corridor promoted by just and reasonable compensation terms; and rational compensation to the owning road.
>
> We believe our revisions to the formula reconcile these goals, and we find the compensation terms just and reasonable. * * * By placing the renter in the same position as the owner, we believe we have achieved our goal of assuring a competitive relationship between the two systems on the line.

In addition, the ICC specifically explained (Pet. App. 151a) (citations omitted) why its methodology was consistent with its guidance to the parties in the original *UP Control* proceeding:

> In permitting the transaction to go forward without the compensation issue resolved, we guaranteed that if we were required to set compensation because of the inability of the parties to agree, the

terms of the trackage rights would not be "so onerous to the tenant as to defeat the purpose of the trackage rights." We did not represent that we would establish terms so favorable to [petitioners] as to ensure their willingness to operate the rights we provided. The methodology we have developed in the *Compensation* decisions, as clarified here, establishes reasonable terms for [petitioners'] use of the involved trackage rights. [Petitioners] ha[ve] no right to expect us to establish compensation on a basis that is less than reasonable. Our refusal to do so can hardly be deemed "to defeat the purpose of the trackage rights." The competitive opportunity created by the trackage rights grant was intended to mitigate the competitive harms that might otherwise have been occasioned by the UP/MP/WP consolidation.

In a footnote, the Commission explained (Pet. App. 151a n.13):

"We have said on numerous occasions that we protect competition, not competitors." *Union Pacific Corp., et al. - Cont. - MO-KS-TX Co., et al.*, 4 I.C.C.2d 409, 460 (1988). "Our primary concern is protecting competition. Transfers of traffic among competing carriers are not grounds for rejection of a proposal or imposition of conditions unless a carrier's ability to provide essential services is threatened." *Rio Grande Industries, et al. - Pur. & Track. - CMW Ry. Co.*, 5 I.C.C.2d 952, 968 (1989). "[A] showing of expected substantial harm to a particular *com-*

> *petitor* as a result of a transaction is not equivalent to a showing of harm to *competition*. For example, a rail or truck competitor might lose traffic precisely because a transaction promises the significant public *benefit* of a new, more improved transport alternative. Harm to the competitor would not be grounds for rejection of a proposal or imposition of conditions unless a carrier's ability to provide essential services is threatened." *Rio Grande Ind., Inc. - Pur. & Track. - Soo Line R. Co.*, 6 I.C.C.2d 854, 875 (1990) (emphasis in original). See also *Canadian Pacific Ltd. - Pur. & Trackage - D&H Ry. Co.*, 7 I.C.C.2d 95, 112 (1990).

3. In this action, petitioners sought review of the ICC's compensation decisions in the D.C. Circuit. They claimed that the ICC's compensation methodology would not allow them to compete with UP and therefore would not serve the purpose for which trackage rights had been awarded in the consolidation proceeding. UP also petitioned for review, challenging several technical aspects of the ICC's methodology. The court of appeals denied the petitions for review in an unpublished *per curiam* opinion. Pet. App. 1a-3a. It observed that the ICC based its decisions on "vast amounts of technical evidence" and "reevaluat[ed] and reformulat[ed] its decisions in light of the objections of the petitioners and the production of new evidence." Pet. App. 3a. The court concluded that petitioners were required "*not* merely to put forth an acceptable alternative but rather to demonstrate *clearly and convincingly* a fatal flaw in the action taken," *ibid.* (quoting *Nader* v. *Federal*

Communications Commission, 520 F.2d 182, 195 (D.C. Cir. 1975)), and had failed to meet that burden.

ARGUMENT

The court of appeals' decision is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Petitioners seek to overturn the ICC's exercise of its expert judgment in fashioning a methodology for computing the compensation to be paid by the tenant (petitioners) to the landlord (UP) for trackage rights awarded as a condition of the approval of a railroad consolidation. As the court of appeals correctly recognized (Pet. App. 3a), petitioners bear a heavy burden. The methodology implements a condition imposed by the ICC when it approved *UP Control*. The ICC is afforded great leeway in ensuring the proper operation of its orders and the conditions it imposes, as the court of appeals recognized in the decision approving the consolidation at issue here. *Southern Pacific*, 736 F.2d at 721; see also *Seaboard Coast Line R.R.* v. *United States*, 599 F.2d 650, 652 (5th Cir. 1979) (citing *Chesapeake & O. Ry.* v. *United States*, 571 F.2d 1190, 1194 (D.C. Cir. 1977)). Deference is especially appropriate in this case, where the ICC has developed a methodology for determining the rental to be charged for trackage rights operations. *Thompson* v. *Texas M. R.Ry.*, 328 U.S. 134, 148 (1946). The court of appeals was therefore correct in according substantial deference to the ICC's decisions. Pet. App. 2a-3a; see, *e.g.*, *Motor Vehicle Mfrs. Ass'n* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 41-42 (1983); see also *National R.R.*

Passenger Corp. v. *Boston & M. Corp.*, 112 S. Ct. 1394, 1403 (1992).

2. The court of appeals was also correct in concluding that the ICC acted within its discretion in formulating the compensation method for petitioners' exercise of trackage rights and adequately explained its reasons for choosing that method. Petitioners' argument to the contrary is based on two erroneous premises.

First, petitioners err in suggesting (Pet. 3-4) that the ICC was required to give overriding consideration to the competitive impacts of the proposed consolidation under 49 U.S.C. 11344(b)(1)(E) when it developed the compensation method. As the court of appeals recognized in affirming *UP Control*, "the Staggers [Rail] Act [of 1980] [49 U.S.C. 11344(b)(1)(E)] is not formally applicable to this proceeding"; nonetheless, "the Commission elected to adhere to its policies." *Southern Pacific*, 736 F.2d at 715-716. The court also recognized in affirming *UP Control* that, contrary to petitioners' present assertion (Pet. 21), nothing in the Interstate Commerce Act or in the ICC's merger policy requires that a consolidation be pro-competitive or prohibits the approval of a consolidation that results in a substantial lessening of competition. See *Southern Pacific*, 736 F.2d at 716-717.

Petitioners also err in asserting that the compensation method adopted in this case reflects a departure from the policy enunciated by the ICC in imposing the trackage rights condition. Petitioners mischaracterize the agency's reason for imposing the condition. As the ICC explained, the Kansas City-to-

St. Louis trackage rights were granted not to benefit petitioners but to allay the anticompetitive impact of the consolidation of three railroads into the UP system. Pet. App. 149a-151a (citing *UP Control*, 366 I.C.C. at 586-589). In particular, the ICC never undertook to prescribe less than reasonable compensation in order to force UP to underwrite petitioners' ability to compete. *E.g.*, Pet. App. 154a.

By formulating a compensation methodology in these decisions that enables petitioners to compete with UP, the ICC fulfilled its mandate under the statute and the court's decision, and acted consistently with the policies that led to the imposition of the conditions in *UP Control*. In addition, as the court of appeals concluded, the ICC adequately explained its reasons for adopting the methodology. Pet. App. 3a.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1993

Supreme Court, U.S.
FILED
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No. 92-1612

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1992

SOUTHERN PACIFIC TRANSPORTATION COMPANY AND ST. LOUIS SOUTHWESTERN RAILWAY COMPANY,
Petitioners,

v.

INTERSTATE COMMERCE COMMISSION AND UNITED STATES OF AMERICA, *ET AL.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR RESPONDENTS UNION PACIFIC CORPORATION, UNION PACIFIC RAILROAD COMPANY AND MISSOURI PACIFIC RAILROAD COMPANY IN OPPOSITION

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LISTING PURSUANT TO RULE 29.1

Pursuant to Rule 29.1, the following corporations are subsidiaries (except wholly owned subsidiaries) of Union Pacific Corporation or of its indirect wholly-owned subsidiaries Union Pacific Railroad Company or Missouri Pacific Railroad Company:

Alameda Belt Line
The Alton & Southern Railray Company
Arkansas & Memphis Railway Bridge & Terminal Company
Automated Monitoring & Control International, Inc.
The Belt Railway Company of Chicago
Brownsville & Matamoros Bridge Company
Camas Prairie Railroad
Central California Traction Company
Denver Union Terminal Railway Company
Houston Belt & Terminal Railway Company
Kansas City Terminal Railway Company
Longview Switching Company
The Oakland Terminal Railway
The Ogden Union Railway & Depot Company
Portland Terminal Railway Company
Portland Traction Company
Southern Illinois & Missouri Bridge Co.
St. Joseph & Grand Island Railway Company
St. Joseph Terminal Railroad Company
Terminal Railroad Association of St. Louis
Texas City Terminal Railway Company
Transportation Data Xchange, Inc.
TTX
Uinta Development Company
Wichita Union Terminal Railway Company

The following companies are parent companies of Union Pacific Railroad Company or Missouri Pacific Railroad Company:

Missouri Pacific Corporation
Union Pacific Holdings Corp.

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PRELIMINARY STATEMENT

Respondents Union Pacific Corporation ("UPC") and its subsidiaries Union Pacific Railroad Company ("UPRR") and Missouri Pacific Railroad Company ("MPRR")[1] submit this brief in opposition to the petition for a writ of certiorari.

This case is not appropriate for review by this Court. SP's[2] Petition rests on a supposed "departure from prior policy" by the Interstate Commerce Commission ("ICC") that in fact never occurred. The ICC consistently justified the particular actions challenged by SP as (a) necessary to place the trackage rights tenant (SP) in the same position as the landlord (UP) with respect to the costs associated with these railroads' joint use of the trackage rights lines, and thus (b) comporting fully with the goal of preserving competition which is one aspect of the ICC's "merger policy."

Moreover, while SP's claim is premised on a complaint that the overall level of compensation set by the ICC does not allow it to compete, its challenge to the ICC's compensation orders relates only to a single aspect of a multi-component compensation formula. SP thereby obscures the fact that in adopting and applying other aspects of its compensation formula, the ICC took actions — challenged by UP at the ICC and before the Court of Appeals — that had a far greater effect *in SP's favor* on the overall level of compensation than the ICC actions SP challenges here. SP completely fails to address whether the *overall* compensation terms diverged in any respect at all from the ICC's prior policies.

Finally, even if SP's characterization of this case were correct, SP's petition would not present an issue of sufficient importance to warrant review by this Court.

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[1] UPRR and MPRR are operated as a single railroad system, and are referred to collectively as "UP."

[2] Petitioners Southern Pacific Transportation Company and St. Louis Southwestern Railway Company are referred to collectively as "SP."

COUNTERSTATEMENT OF THE CASE

SP's Petition rests on a selective and misleading characterization of the agency and judicial review proceedings out of which this case arises.

A. The UP-MP-WP Merger

SP seeks review of a decision by the United States Court of Appeals for the District of Columbia Circuit denying review of five ICC orders establishing compensation terms to govern SP's use of trackage rights over certain UP lines that were granted to SP in 1982 in connection with the ICC's approval of the consolidation of UPRR, MPRR, and the Western Pacific Railroad Company in *Union Pacific Corp., Pacific Rail System, Inc., & Union Pacific R.R. — Control — Missouri Pacific Corp. & Missouri Pacific R.R.*, 366 I.C.C. 462 (1982), *aff'd in relevant part sub nom. Southern Pacific Transportation Co. v. United States*, 736 F.2d 709 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1208 (1985) ("*UP-MP-WP*").[3] In approving the UP-MP-WP transaction, the ICC was exercising its plenary and exclusive authority over railroad consolidations. 49 U.S.C. § 11341(a). That role encompassed consideration of all factors relevant to the ICC's broad mandate to determine whether approval of the transaction "is consistent with the public interest." 49 U.S.C. § 11344(c). One such factor is the effect of the transaction on "competition among rail carriers in the affected region." 49 U.S.C. § 11344(b)(1)(E); *see also UP-MP-WP*, 366 I.C.C. at 501-02. In passing upon the consolidation,

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[3] The ICC established the compensation terms at issue in five published decisions in *St. Louis Southwestern Ry. — Trackage Rights Over Missouri Pacific R.R. — Kansas City to St. Louis*, 1 I.C.C.2d 776, Pet. App. 7a (1984) ("*Compensation I*"), 4 I.C.C.2d 668 (1987), Pet. App. 64a ("*Compensation II*"), 5 I.C.C.2d 525 (1989), Pet. App. 121a ("*Compensation III*"), 8 I.C.C.2d 80 (1984), Pet. App. 144a ("*Compensation IV*"), 8 I.C.C.2d 213 (1991), Pet. App. 189a ("*Compensation V*").

however, the ICC was not applying the federal antitrust laws, contrary to SP's suggestion (Pet. 4-5), nor was the ICC bound to adhere rigidly to the analytical principles applied by antitrust courts. *UP-MP-WP*, 366 I.C.C. at 502. To the contrary, the ICC's consistent policy has been to "reject the contention that antitrust considerations might assume controlling importance in railroad consolidations." *Id.* Instead, the ICC regards competition as "but one factor, albeit an important one, in determining the public interest." *Id.* at 503.

The ICC conditioned its approval of the UP-MP-WP transaction on a grant to SP and the Denver and Rio Grande Western Railroad Company ("DRGW"), another railroad that has since become part of SP's corporate family (Pet. 9 n.8), of rights to operate trains over lines of the combined UP-MP-WP system between Pueblo, Colorado, and St. Louis, Missouri. The ICC granted to DRGW trackage rights between Pueblo and Kansas City in order to establish an alternative to the new UP-MP-WP system for transcontinental freight traffic moving in the so-called "Central Corridor" between California and the Eastern United States. *UP-MP-WP*, 366 I.C.C. at 577; *Compensation I*, 1 I.C.C.2d at 778, Pet. App. 10a. These trackage rights connected DRGW's system with the major Eastern railroads serving Kansas City and thereby served to ensure "a continued competitive presence in the central corridor." *Id.* at 778, Pet. App. 10a.

"To further strengthen" this "central corridor alterative to UP," the ICC also granted trackage rights to SP over MPRR's lines between Kansas City and St. Louis (hereafter "the trackage rights lines") — the most valuable single segment in MPRR's entire system — thereby creating an efficient SP-DRGW-SP Central Corridor route all the way from the West Coast to St. Louis. *Id.* at 779, Pet. App. 12a; *see also* Pet. 7 & n.7. SP argued for this grant in part because the ability to operate over MPRR's first-class trackage would avoid the need for SP to spend upwards of

$100 million to rehabilitate its own line between Kansas City and St. Louis. *UP-MP-WP*, 366 I.C.C. at 586.

B. SP's Use of the Kansas City-St. Louis Trackage Rights

When it imposed these trackage rights conditions incident to its approval of the UP-MP-WP transaction, the ICC did not establish the specific compensation and other terms that would govern those rights. Rather, the ICC instructed the parties to attempt to reach agreement on compensation terms and retained jurisdiction to establish terms if the parties failed to agree.

UP and DRGW ultimately agreed on permanent compensation terms, but UP and SP were unable to reach agreement. UP and SP agreed that SP would be required to pay the share of maintenance and operating expenses attributable to SP's use of the trackage rights lines, but were unable to agree on the level of rent necessary to compensate UP for its substantial capital investment in the assets comprising the Kansas City-St. Louis line segment. In 1983, UP and SP petitioned the ICC to establish permanent compensation terms. The compensation proceedings at the ICC — which lasted over eight years and generated five published ICC decisions — centered on the question of rental.

The parties' inability to agree to permanent terms, however, did not delay SP's commencement of operations over the lines. Since January 1983, SP has been operating several trains per day using the trackage rights lines — accounting for approximately 25% of the total usage made of the lines. SP has been voluntarily paying a small amount as rent, but by agreement the rental will be retroactively adjusted with interest upon the final completion of judicial review in this case to reflect the compensation terms imposed by the ICC. *Compensation I*, 1 I.C.C.2d at 792, Pet. App. 34a-35a; *Compensation IV*, 8 I.C.C.2d at 101 n.34, Pet. App.

171a n.34. As of March 1, 1993, the rental payments that UP had received from SP totaled over $54 million less than the amount required by the terms imposed by the ICC.[4]

During the pendency of the ICC compensation proceedings, changes in "the competitive and operating environments of the railroads involved" fundamentally altered SP's need for the trackage rights to compete against UP in the Central Corridor. In 1988, SP and DRGW came under common control. Then, in 1990, SP acquired trackage rights over the Burlington Northern Railroad Company between Kansas City and Chicago, giving SP its own route between central California and connection with all major Eastern railroads at the preeminent Chicago rail hub. *Compensation IV*, 8 I.C.C.2d at 87-88 n.14, Pet. App. 154a n.14. The effect of these developments was to diminish, if not eliminate, SP's need for access to the trackage rights lines in order to compete in the transcontinental Central Corridor.

C. The ICC's Compensation Proceedings

1. The Goal of the Proceedings

The ICC's compensation proceedings did not present the choice between conflicting regulatory goals that SP's Petition suggests. Throughout the proceedings, the ICC adhered to its policy that SP should pay compensation for use of the trackage rights that would give SP and UP the same opportunity to compete using the trackage rights lines. Specifically, the ICC articulated as its guiding principle the goal of assuring that SP would be "put . . . in the same

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[4] In 1990, when the ICC's compensation formula had become sufficiently definite to allow calculation of the precise amount of rent owed by SP, MPRR initiated an action in United States District Court for the District of Nebraska to collect the amounts owing to UP under the ICC's orders. *Missouri Pacific R.R.* v. *Southern Pacific Transportation Co.*, No. CV90-0-383 (D. Neb., filed June 15, 1990). That action is being held in abeyance pending the completion of judicial review herein.

position as the owning carrier" with respect to the costs associated with the lines that both railroads would use, allowing "SP . . . to operate with a cost structure competitive to that of the UP on these lines." *Compensation I*, 1 I.C.C.2d at 786, 802, Pet. App. 24a, 50a-51a. By bearing its share of UP's ownership costs in the form of rent, SP would have the same opportunity as UP to use the trackage rights lines to compete for Central Corridor traffic, and neither railroad would be subsidizing the other's operations. This goal of "parity" is the same goal that SP has contended the ICC was required to follow in this case. Pet. 10-11, 12.

Contrary to SP's contention, moreover, this goal was in no respect inconsistent with the goal of "revenue adequacy." Pet. 11. Rather, from the outset the ICC recognized that one of the economic costs borne by UP and every other railroad that owns trackage and other assets is a return based on the railroad-industry cost of capital applied to the current value of the asset in question. Such capital costs must be covered to prevent disinvestment in the landlord's operations. Incorporating this very real landlord cost into the trackage rights compensation terms to be paid by SP was thus regarded by the ICC as necessary for two reasons: *first*, to place UP and SP on equal footing with respect to line costs, thus preventing the trackage rights from effecting a "cross subsidy from the landlord or its customers," *Compensation II*, 4 I.C.C.2d at 683, Pet. App. 86a (quotation omitted); and *second*, to fulfill the congressional policy of "'allowing rail carriers to earn adequate revenues,'" *id.* at 682, Pet. App. 85a (quoting 49 U.S.C. § 10101a(3)).

The supposed "tension" between these goals (Pet. 10) is entirely of SP's own fabrication. The purported inconsistency arose only when SP shifted from arguing that the ICC intended to provide it with a fair "competitive opportunity" — the aim the ICC did accomplish — to contending that the ICC was required to guarantee SP's *success* in competing with UP. Such a guarantee of outcomes, however, was never a

part of the ICC's merger policy. *See Compensation IV*, 8 I.C.C.2d at 85 & n.13, Pet. App. 151a & n.13. Although the ICC wished to enable SP to provide shippers with an alternative to UP's Central Corridor route, it made no attempt to guarantee that shippers would find SP's overall package of rates and service equally or more attractive than that offered by UP, or even that SP would necessarily choose to operate the trackage rights. *Id.* SP's success in winning shippers' business would inevitably depend on countless factors having nothing to do with compensation for the small portion of SP's overall transcontinental route represented by the trackage rights lines — including the quality of services SP offered, the efficiency of its operations in running trains carrying the transcontinental traffic as to which it would be competing against UP (both over its own and the trackage rights lines), and the ownership costs associated with SP's own lines.

In light of the ICC's more limited goal of creating a level playing field, it is not surprising that the ICC repeatedly rejected SP's efforts to have the ICC consider evidence of the competitive *outcomes* resulting from SP's use of the trackage rights lines. That evidence was simply not relevant to whether compensation terms had properly placed SP and UP "in the same position" with respect to line costs. *Compensation III*, 5 I.C.C.2d at 538-39, Pet. App. 139a-140a; *Compensation IV*, 8 I.C.C.2d at 95, Pet. App. 164a; *Compensation V*, 8 I.C.C.2d at 217 & n.12, 218 & n.16, Pet. App. 194a & n.12, 196a & n.16.

2. The Issues Before the ICC

Nor, as SP suggests (at Pet. 9-11), did the compensation proceedings focus on the single "issue" of the appropriate rate of return used to calculate SP's rental obligations. Establishing the appropriate level of SP's rental payments required the resolution of three equally-indispensable issues, not one. The ICC had to develop (1) a valuation of the trackage rights lines, (2) a rate of return to be applied to the

valuation base, and (3) a formula for allocating the resulting overall capital costs between the railroads using the lines. Each of these basic methodological elements required the ICC to resolve numerous subsidiary but often highly controversial factual issues. Although SP now complains that the ICC erred in its choice of the rate of return, the ICC also rejected arguments made by UP which challenged (a) the ICC's determination of the value of the trackage rights lines, addressed immediately below, and (b) the allocation of total capital costs between UP and SP.[5]

a. Valuation of the Trackage Rights Lines

Although there is no mention of it in SP's Petition, the valuation of the trackage rights lines was the most extensively disputed single issue in the compensation proceedings. UP's position before the ICC was that it should receive rent computed using a rate of return equal to the railroad-industry cost of capital and a valuation base derived from the reproduction cost new less depreciation ("RCNLD") of the trackage rights lines. UP submitted evidence establishing that rental payments should reflect the landlord's true economic costs, and that rent at that level was essential to place the landlord and tenant on equal footing with respect to the lines' costs. Had UP's position been adopted by the ICC, it would have mandated overall rent several times higher than that which SP now challenges. SP, on the other hand, favored valuing the lines based on their much lower ledger value — but the ICC ultimately set an even *lower* value.

In *Compensation I*, the ICC rejected both the RCNLD and ledger value approaches in favor of a purchase-price-

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[5] UP argued that total capital costs should be allocated to UP and SP on a 50-50 basis, since SP was granted the unlimited right to use UP's property in common with UP. The ICC rejected this approach in favor of a "rolling-average usage" allocation method favored by SP. *Compensation I*, 1 I.C.C.2d at 790, Pet. App. 30a-31a; *Compensation II*, 4 I.C.C.2d at 687, Pet. App. 92a-93a.

based method — referred to as the "capitalized-earnings approach" — that calculated the value of the lines based on a highly-complex allocation of the price paid by UP in 1979 when it acquired Missouri Pacific Corporation ("MPC"). (One part of MPC was the MPRR system, which in turn included the trackage rights lines.) That allocation involved, *inter alia*, estimation of an "earnings multiplier" for MPC's railroad earnings, and estimation of the earnings attributable to the trackage rights lines, which comprised only a physically small but strategically vital part of the MPRR system. *Compensation I*, 1 I.C.C.2d at 787-90, 801-02, Pet. App. 25a-31a, 50a-51a.

Developing the value of the lines in this manner consumed the better part of six years and three ICC decisions. Following the ICC's adoption of the capitalized earnings approach, UP expressly preserved for appeal its position that the basic methodological choice was unsound, and that an RCNLD valuation — coupled with a rate of return based on the cost of capital — was necessary to ensure that the tenant paid its fair share of the landlord's costs. *See Compensation II*, 4 I.C.C.2d at 672 n.4, Pet. App. 70a n.4. The ICC's application of the capitalized earnings approach had resulted in one revision after another in the ICC's valuation of the trackage rights lines, virtually every one of which was made in SP's favor and over UP's objections. The end result of the ICC's deliberations was a valuation approximately one-sixth of the RCNLD value for which UP had argued, *and below even the ledger value for which SP had initially argued*. *Compare Compensation IV*, 8 I.C.C.2d at 82 n.6, Pet. App. 147a n.6, *with Compensation I*, 1 I.C.C.2d at 800, Pet. App. 47a.

b. Rate of Return

In its choice of the railroad-industry cost of capital as the rate of return, by contrast, the ICC consistently adhered to its principle of placing the landlord and tenant in positions of

parity with respect to line costs. The ICC explained that it was adopting the railroad-industry cost of capital because rent based on that rate of return was necessary to ensure "that the renting carrier is not subsidized by the owning road." *Compensation II*, 4 I.C.C.2d at 682, Pet. App. 86a.

The ICC adhered to this view when it rejected SP's proposal, made for the first time in 1988, that the rate of return be based on UP's own "floating" rate of return.[6] SP argued, as it did before the Court of Appeals and does again here, that use of the cost of capital would place SP in an "inferior position" vis-à-vis UP, allegedly breaching the principle of "competitive equality." *Compensation III*, 5 I.C.C.2d at 534, 535, Pet. App. 133a, 135a. The ICC expressly disagreed with SP's position, and again explained that the rate of return it was adopting would produce a sharing of costs between UP and SP that "places the parties on identical and competitive footing *and* ensures continued joint provision of service and adequate reinvestment." *Id.* at 530, Pet. App. 127a-128a (emphasis added).[7] Allowing SP to pay rent based on any rate of return less than the railroad-industry cost of capital would "force UP to subsidize its competitor SP." *Id.* at 536, Pet. App. 135a. The ICC further explained that SP's "floating rate" proposal did not "address the fundamental problem of cross-subsidization." *Id.* at 538, Pet. App. 139a.

In *Compensation V*, the ICC rejected yet again SP's "floating rate" of return proposal (advanced in conjunction with SP's same arguments about its supposed competitive

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[6] SP had initially argued for rent based on a 4% rate of return, a rate SP chose because it had been used in a 1904 agreement between the railroads. *Compensation I*, 1 I.C.C.2d at 799, Pet. App. 46a.

[7] The ICC reiterated the same point in its summary of the prior compensation proceedings in *Compensation IV*, 8 I.C.C.2d at 96-97, Pet. App. 166a, a decision that was otherwise devoted to clarification of various aspects of the ICC's compensation formula not pertinent here.

disadvantage). 8 I.C.C.2d at 215-18, Pet. App. 192a-196a. The ICC stressed: "All of [SP's] arguments have been made before, have been considered before, and have been rejected before." *Id.* at 217, Pet. App. 194a.

In both *Compensation III* and *Compensation V* the ICC also rejected the precise claim that SP now rehashes before this Court — namely, that the ICC's use of the cost of capital marked a reversal of the ICC's prior decisions in the case and departed from the policy of "competition" underlying the ICC's imposition of the trackage rights in the *UP-MP-WP* case. *See Compensation III*, 5 I.C.C.2d at 537-38, Pet. App. 138a-139a; *Compensation V*, 8 I.C.C.2d at 215-18, Pet. App. 192a-196a.

D. The Proceedings in the Court of Appeals

Both UP and SP filed petitions for review of the ICC's compensation orders in the D.C. Circuit, which the Court of Appeals consolidated in Docket No. 88-1186. UP and SP each challenged aspects of the ICC's compensation orders and defended other aspects of those orders. As pertinent here, SP contended that the ICC had erred in rejecting SP's proposed "floating" rate of return approach. UP argued that the ICC erred in rejecting UP's proposed RCNLD approach to valuation, which UP again explained was compelled by the same policy of parity that the ICC had followed in adopting the railroad-industry cost of capital as the rate of return — namely, to ensure that the landlord and tenant shared equally in the true economic costs associated with the trackage rights lines. D.C. Cir. No. 88-1186, Brief of Petitioners-Intervenors Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company at 33-34 (April 10, 1992). UP also argued that the ICC had erred in its approach to allocating total capital costs between the users of the lines and in applying the capitalized earnings approach to determine the valuation base.

After full briefing and oral argument, the D.C. Circuit rejected both parties' petitions for review in an unpublished Memorandum Order, finding all aspects of the ICC's orders to be supported by substantial evidence on the record. While the Court of Appeals noted that the approaches advocated by both UP and SP before the ICC might have had some merit, it concluded that the ICC had acted within its discretion in choosing a different course. Slip Op. at 2, Pet. App. 3a. The court emphasized that the ICC had "considered vast amounts of technical evidence, reevaluating and reformulating its decisions in light of the objections of the petitioners and the production of new evidence." *Id.*

SP's petition for rehearing and suggestion for rehearing *en banc* advanced the same issues that SP repeats yet again in this Petition. Those requests were denied by the D.C. Circuit without a request for a response to SP's arguments. This Petition followed.

REASONS FOR DENYING THE WRIT

The Petition presents no valid basis for reviewing the Court of Appeals' order denying review of the ICC's five compensation orders.

I. THE COURT BELOW PROPERLY DID NOT APPLY *STATE FARM* TO THIS CASE

SP's Petition asks this Court to "clarify the application and requirements of" *Motor Vehicles Manufacturers Association* v. *State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983). Pet. 23. *State Farm* held that an agency must explain its departure from its established policy and precedents. 463 U.S. at 51, 56-57. The premise of SP's request is its claim that the "ICC departed from its merger policy when it set compensation" and "neither acknowledged nor explained the abandonment." Pet. i, 16 (emphasis

omitted). Contrary to SP's assertions, however, the ICC consistently adhered to its merger policy in establishing compensation terms to govern the trackage rights granted to SP in *UP-MP-WP*. As a result, the facts of this case simply do not raise the question SP presents for this Court's review. The Court of Appeals properly did not apply *State Farm* because the predicate for its application did not exist in this case.

A.

The core defect in SP's Petition is its failure, now for the fifth time in this case,[8] to come to grips with the consistency between the ICC's adoption of the railroad-industry cost of capital as the rate of return used to calculate rent and the ICC's "pro-competitive" policy of placing the landlord and tenant in the same position with respect to the costs of using the trackage rights lines, which even SP concedes comported with the ICC's "policy" in the *UP-MP-WP* merger case of giving SP the opportunity to provide a competitive alternative to UP. *See* Pet. 12.

The ICC's consistent adherence to this policy is demonstrated compellingly by the ICC's repeated articulations of the reasoning behind its choice of the cost of capital — *i.e.*, that it "places the parties on identical and competitive footing" (*Compensation III*, 5 I.C.C.2d at 530, Pet. App. 127a) and avoids having "UP . . . subsidize its competitor SP" (*id.* at 536, Pet. App. 135a).

The same conclusion follows inevitably from the ICC's finding that the railroad-industry cost of capital represented a

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[8] SP's identical contention that use of the cost of capital placed it at a competitive disadvantage vis-à-vis UP and thus marked a departure from the ICC's merger policy was rejected by the ICC in *Compensation III* and *Compensation V* and by the Court of Appeals when it denied SP's petition for review and SP's petition for rehearing and suggestion of rehearing *en banc*.

true economic cost borne by the owning railroad. *E.g.*, *id.* at 529-30, Pet. App. 127a. UP explained to the Court of Appeals that voluminous evidence had been presented to the ICC — including by SP's own expert witnesses — establishing that the railroad cost of capital was a real economic cost borne by UP with respect to its ownership of the trackage rights lines. SP itself was compelled to concede this point in its Reply Brief. D.C. Cir. No. 88-1186, Reply Brief of Petitioners Southern Pacific Transportation Company and St. Louis Southwestern Railway Company at 13-14 (June 10, 1992). Although SP may believe that it should not have to share in this cost unless UP fully passes the cost on in the rates it charges to shippers,[9] SP never identified any reason why the ICC acted unreasonably in concluding that *all* costs borne by UP must be shared by SP if the railroads using the trackage rights lines are to have identical cost structures and so compete on an "identical competitive footing."

SP's effort to draw a supposed distinction between policies of "preventing any substantial lessening of competition and merely preventing monopoly pricing" (Pet. 15) does not overcome this fundamental defect in SP's claim that *State Farm* is applicable to this case. In fact, the ICC consistently adhered to the very same policy that SP says is the appropriate one — namely, the "pro-competitive goal" of placing the "'tenant [SP/DRGW] in precisely the position of the owning road [UP].'" Pet. 12 (emphasis omitted) (quoting *Compensation I*, 1 I.C.C.2d at 786, Pet. App. 24a). That this also served to prevent "monopoly pricing" does not

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[9] UP explained to the Court of Appeals, however, that there was ample evidence in the record for the ICC to conclude that UP's actual rate of return for the trackage rights lines was at least equal to the railroad-industry cost of capital. D.C. Cir. No. 88-1186, Intervenors' Brief of Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company ("UP's Intervenors' Brief") at 6 n.6 (May 27, 1992).

introduce any inconsistency.[10] Thus, this case involves no "change of policy" (Pet. 15) as to which this Court might clarify the application of *State Farm*.

Finally, SP attempts to make something of the Court of Appeals' comment to the effect that the ICC had not "fully explain[ed] why [UP and SP's] suggested approaches [to trackage rights compensation] were inferior to its own." Slip Op. at 2, Pet. App. 3a; *see* Pet. 16. SP contends that this failure to explain was inconsistent with the requirements of *State Farm*. Pet. 16. The crucial gap in SP's reasoning, however, remains the same, since there still exists no "departure from prior policy" that the ICC was under any obligation to explain.

It is apparent here, as it was before the Court of Appeals, that SP's real complaint with the ICC's compensation orders is that the ICC did not manipulate the terms of trackage rights compensation so as to guarantee that SP would *succeed* in competing against UP using the trackage rights lines. The ICC properly recognized that such a guarantee would be totally foreign to the ICC's goal of establishing SP's access to the trackage rights lines on a level playing field with the owning railroad. SP's contrary view has been repeatedly rejected by the ICC and the Court of Appeals, and presents no occasion for this Court's review.

B.

An equally fatal flaw in SP's position before this Court is SP's effort to assail in isolation one aspect of the compensation formula adopted by the ICC. The premise of

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[10] The ICC never said, as SP claims, that the trackage rights had been intended "*only*" to enable SP to offer "a competitive alternative 'if UP were to engage in *monopolistic* pricing practices.'" Pet. 21 (quoting *Compensation IV*, 8 I.C.C.2d at 86, Pet. App. 152a) (both emphases SP's). The word "only" is SP's word, not the ICC's.

SP's sole critique of the ICC's orders is that the ICC departed from its merger policy when it imposed compensation terms that had the effect of creating "a competitive handicap for SP." Pet. 23. If any such handicap really exists, of course, it must be the result of the *overall* compensation terms imposed by the ICC, since that is the basis for the payments SP is required to make for its use of the trackage rights lines. As UP demonstrated to the Court of Appeals, the overall rent "is the product of three equally-indispensable elements: the rate of return, the valuation base, and the allocation share." UP's Intervenors' Brief at 3. Yet SP's entire focus, both in this Petition and before the Court of Appeals, has been on only a single element of this formula — use of the cost of capital as the rate of return. Pet. 22-23.

As a result, SP fails here, as it did before the Court of Appeals, even to *address* whether the overall level of the ICC-imposed compensation was reasonable under the standard of *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). Nor has SP spoken to the central question raised by SP's own effort to implicate *State Farm* — *i.e.*, whether the overall level of compensation ultimately imposed by the ICC has deviated from the ICC's policy of providing SP with the opportunity to compete on an equal basis with UP for Central Corridor transcontinental traffic.

This failure is particularly crippling where, as here, UP demonstrated to the Court of Appeals that numerous important steps taken by the ICC in developing the other elements of the rental calculus had substantially greater effects on the overall level of compensation, *in SP's favor*, than the single issue on which SP has focused its attention.[11]

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[11] SP concedes as much when it points out that UP argued before the Court of Appeals that the ICC severely undervalued the trackage rights lines. Pet. 15 n.14. SP's suggestion that UP was thereby trying to create "an even greater cost disadvantage to SP" acknowledges (in a backhanded way) that the ICC could have imposed on SP considerably higher total (continued...)

Moreover, UP established that its rejected RCNLD valuation approach, which would have dramatically increased overall compensation regardless of which approach was adopted for rate of return, was the *only* method consistent with the goal now purportedly championed by SP of placing the landlord and tenant on equal footing. SP has totally failed to show that the Commission's failure to set an even lower rental rate amounted to an "abandonment" of the Commission's merger policy.

II. THE ISSUE PRESENTED IN THE PETITION IS NOT IMPORTANT ENOUGH TO WARRANT REVIEW BY THIS COURT

Even as SP has framed the issue, moreover, the case presents no important matter of policy that warrants discretionary review by this Court. The decision of the Court of Appeals upholding the ICC's orders in all respects presents no conflict with any decision of another court of appeals or of this Court. Nor is there any important unsettled question of federal law that should be resolved by this Court. At most, this case represents the application of well-established principles of judicial review to the unique and highly particularized facts of this decade-long compensation proceeding in which the ICC "considered vast amounts of technical evidence, reevaluating and reformulating its decisions in light of the objections of the petitioners and the production of new evidence." Slip Op. at 2, Pet. App. 3a.

SP's own request for relief underscores the lack of general public importance of this case. SP urges clarification by this Court of the "application and requirements" of *State Farm* (Pet. 23). Such a clarification, even if it were called for here, would at best add marginally to the jurisprudence in

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[11](...continued)
rental even if it had entirely acceded to SP's approach to the rate of return.

a well-settled field of the law. More likely, it would have no meaningful impact beyond the parties to this case. How much money SP is required to pay UP for its use of the trackage rights lines is not an issue of wide public importance. And any public policy importance that SP's ability to compete for Central Corridor traffic using the trackage rights lines might once have had substantially disappeared when SP acquired its own route for this traffic that does not require it to use the trackage rights lines (*see* page 5 *supra*). At most, therefore, this Court's further review of the ICC's compensation orders would accomplish a revision in the amount of money SP is required to pay UP when this case is over, hardly a matter demanding the attention of this Court.

Moreover, despite SP's effort to dress up the mundane question purportedly presented by this Petition — *i.e.*, the application of *State Farm* to the "ICC's implementation of a condition" — as involving a "problem" of "general" application (Pet. 18) which is "essential to the proper administration of the rail merger provisions of the Interstate Commerce Act" (Pet. 17), that question has no such policy importance. SP has not pointed to any uncertainty concerning the proper application of *State Farm* in cases where (unlike here) an agency has actually departed from settled policy. Nor has SP identified even a single ICC merger case — present or future — that would be affected by this Court's involvement in the present dispute.

The inappropriateness of a grant of SP's petition is emphasized by the plain fact that SP's Petition to this Court is merely the last step in SP's strategy of drawing out for as long as possible the ICC compensation proceedings and judicial review thereof, in order to forestall paying UP the tens of millions of dollars it owes under the ICC's orders for its use of UP's lines to date. Those payments will become payable as soon as judicial review is completed, which will occur when this Court denies SP's Petition.

CONCLUSION

For the foregoing reasons, the Court should deny the petition for a writ of certiorari.

Respectfully submitted,

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